# INDIA'S FINANCIAL SECTOR
# AN ASSESSMENT

## Volume II

## Overview Report

**Committee on Financial Sector Assessment**

**March 2009**

भारत सरकार
GOVERNMENT OF INDIA

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

The findings, views and recommendations expressed in this Report are entirely those of the Committee on Financial Sector Assessment and should not be interpreted as the official views of the Reserve Bank of India or Government of India.

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**LETTER OF TRANSMITTAL**

Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

Reserve Bank of India
Central Office
Shaheed Bhagat Singh Marg
Mumbai

March 20, 2009

Dear Hon'ble Finance Minister,

**Report of the Committee on Financial Sector Assessment**

We have great pleasure in submitting the Report of the Committee on Financial Sector Assessment (CFSA).

The Government of India, in consultation with the Reserve Bank of India, constituted the CFSA to undertake a comprehensive self-assessment of India's financial sector. The assessment has drawn upon the experience gained from the earlier self-assessment of international financial standards and codes and the standards assessments carried out by the International Monetary Fund and the World Bank.

The CFSA has followed a constructive and transparent approach to self-assessment keeping in view that such a self-assessment must be a rigorous and impartial exercise, with appropriate checks and balances.

The Report of the CFSA is being released in six volumes. Apart from the overview report and its executive summary, the other volumes comprise the Advisory Panel Reports on Financial Stability Assessment and Stress Testing, Financial Regulation and Supervision, Institutions and Market Structure, and Transparency Standards. Each of the Advisory Panel Reports has been reviewed by expert international peer reviewers.

Even while the impact of the recent global financial turmoil is still unfolding, the CFSA hopes that this assessment would enhance the understanding of the Indian financial sector, both in India and abroad. We would earnestly urge the Government of India, the Reserve Bank, SEBI, IRDA and other concerned market participants to promote wide dissemination and debate and initiate policy actions for improving the structural aspects of the Indian financial architecture.

We would also like to acknowledge the generous help and time given by the Chairmen and members of the Advisory Panels, the external peer reviewers and all officials and colleagues from the Government, regulatory and other institutions associated with this exercise.

With warm regards

Yours sincerely,

(Ashok Chawla)
Co-Chairman and
Secretary, Department of Economic Affairs
Ministry of Finance
Government of India

(Rakesh Mohan)
Chairman and
Deputy Governor
Reserve Bank of India

Shri Pranab Mukherjee
Minister of Finance
Government of India
New Delhi - 110 001.

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Department of Economic Affairs
Ministry of Finance
Government of India

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Joint Secretary (Fund-Bank)
Department of Economic Affairs
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Government of India
(from October 23, 2008)

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Joint Secretary (Fund-Bank)
Department of Economic Affairs
Ministry of Finance
Government of India
(September 13, 2006 - October 22, 2008)

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# PREFACE

It is well-recognised, particularly after the East Asian crisis of 1997, that in an environment of large cross-border capital flows, which increased dramatically in the past two decades, the financial sector must be resilient and well-regulated. The fact that advanced financial markets, with well-tested monetary policy and regulatory frameworks, are also not free from such unexpected and extraordinary developments, has become very evident in the ongoing global financial crisis. In this context, the Financial Sector Assessment Programme (FSAP), a joint IMF/World Bank initiative introduced from May 1999 has aimed at identifying the strengths and vulnerabilities of a country's financial system; to determine how key sources of risk are being managed; to ascertain the financial sectors' developmental needs; and to help prioritise policy responses. These objectives are sought to be achieved through financial system stability assessment (FSSA) by undertaking macroeconomic surveillance and assessment of stability and soundness of the financial system in all its facets or the entire gamut of the financial system, *viz.*, institutions, markets and infrastructure. A detailed assessment of observance of relevant financial standards and codes which gives rise to Reports on Observance of Standards and Codes (ROSCs) as a by-product is an integral part of FSAP – either undertaken as part of FSSA or independently. Overall, an FSAP enhances the scope for strengthening resilience and fostering financial stability within and helps promote smoother integration of economies with the global markets.

Member countries' participation in both FSAPs/ROSCs and the publication of related reports is voluntary. Hence, the effectiveness of these assessments hinges upon the ownership of and commitment to the process from member country authorities. In the approximately ten years since the FSAP began, about three-quarters of IMF and World Bank member countries have completed or requested an initial assessment. The IMF/World Bank has begun in recent times to focus upon updates of the FSAP. It is significant that among the countries that have not been comprehensively covered yet are some advanced countries among the G-7 and emerging markets among the G-20 Group – though some ROSCs have been completed by many of these countries in a sporadic manner.

India was one of the earliest member countries that participated voluntarily in the Financial Sector Assessment Programme (FSAP) exercise in 2000-01. Based on mutual consultations between the Government and the Reserve Bank, an elaborate self-assessment exercise on standards and codes was also conducted during 2000-02. In this exercise, India undertook a comprehensive self-assessment in all of 11 international financial standards and codes under the aegis of the Standing Committee on International Financial Standards and Codes, with Anti-Money Laundering (AML)-Combating the Financing of Terrorism (CFT) Recommendations assessed by a separate Working Group. These reports served as benchmarks for understanding the status as also for initiating several legal and institutional reforms in the financial sector. Thereafter, a review of the follow-up action taken on the recommendations of the 11 Groups mentioned above was completed in January 2005. India also completed assessments by the Bank-Fund of most of the financial standards by December 2004, except for those relating to insurance.

Building upon the experience thus far, the Government of India, in consultation with the Reserve Bank, decided to undertake a comprehensive self-assessment of the financial sector and for that purpose constituted the Committee on Financial Sector Assessment (CFSA) in September 2006. It needs to be mentioned that standards themselves are evolving and getting modified. Since the last FSAP in 2000-01, India has also undertaken a series of continuing reforms over this period. The financial sector reforms undertaken since the early 1990s have no doubt borne fruit: the country has reached a higher growth trajectory; savings have increased and investment into productive activities has expanded significantly; the financial markets have gained depth, vibrancy and more efficiency; and capacity-building overall is embedded in the system.

The CFSA, therefore, decided to undertake a full-scale and fresh assessment instead of updating earlier assessments. Also, instead of a selective approach, the CFSA decided to cover assessments of all financial standards and codes, so that a compact roadmap in a medium-term perspective for the entire financial sector could evolve in persevering with convergence towards international best practices. The current assessment, however, builds upon the earlier FSAP and ROSCs as needed and relevant. These reports were indeed educative. The current effort of the CFSA is, thus one more step in carrying forward the self-assessment approach, further

enabling financial sector stability assessment and stress testing for the first time. The timely publication in September 2005 of the comprehensive Handbook on Financial Sector Assessment by the IMF and the World Bank enabled the initiation of this exercise. In addition, the assessors have also taken into account the Guidance notes, manuals and questionnaires that have been provided to the CFSA by the international standard-setting bodies. We take this opportunity to acknowledge and thank all of the institutions and standard-setters who have encouraged this effort.

The CFSA has followed a constructive and transparent approach to self-assessment, keeping particularly in view that such a self-assessment must be seen as a rigorous and impartial exercise. This unique experiment undertaken by India would, however, amply demonstrate that it is possible to achieve objectivity and credibility through self-assessments, if accompanied by appropriate checks and balances. In this regard, we would like to highlight the salient features of the broad approach and the work process designed by the CFSA.

*Three Pillars of Assessment*

The CFSA followed a forward-looking and holistic approach to self-assessment based on three mutually-reinforcing pillars:

Pillar I : Financial stability assessment and stress testing;
Pillar II : Legal, infrastructural and market development issues; and,
Pillar III : Assessment of the status and implementation of international financial standards and codes.

The first pillar (Pillar I) is essentially in the nature of stability assessment which utilises analytical tools for quantifying the risks and vulnerabilities in the financial sector. The attempt entails an assessment of the systemic risks at the macro and sectoral levels. This involves a comprehensive analysis and interpretation of financial data pertaining to various constituents of the financial sector. *viz.*, banking, securities, insurance, non-banking financial institutions, and corporates as also the fiscal and external sectors. It also includes stress testing for the key risks identified.

The second pillar (Pillar II) focuses on the developmental issues of the financial sector, concentrating upon the legal and institutional infrastructure for prudential regulation and supervision, payment and settlement systems, liquidity management and the crisis-mitigating financial safety nets. It also addresses the extent of coverage of the financial sector and the strength and adequacy of financial intermediation, both in the urban and rural segments.

The third analytical component of financial sector assessment encompasses a comprehensive assessment of the status and implementation of international financial standards and codes (Pillar III).

The CFSA envisaged that in view of the updates to standards that have taken place since the earlier FSAP in 2001, there is a need to take a fresh view on the developments in this area and their current status, duly taking into account the specific features of the Indian financial system. Towards this end, apart from considering the earlier review of self-assessment on standards and codes, the assessments of respective standards made by the IMF and the World Bank have also been taken on board.

*Framework*

We now provide an overview of the framework evolved by the CFSA in its work process.

First, as the assessment involved comprehensive technical knowledge in respective areas, the CFSA constituted Technical Groups comprising mainly officials with first-hand experience in handling the respective subject areas from the concerned regulatory agencies and the Government. The Technical Groups, based on their functional domain knowledge, thus undertook the preliminary assessment, and prepared technical notes and background material in the concerned subject areas. The greatest advantage of this approach has been that the concerned operating officials who have great familiarity with their own systems, who know where weaknesses exist and can also identify best alternative choices for finding solutions, were involved in this work. Moreover, this experience also operated as a very useful capacity-building exercise for the agencies and officials participating in it.

Second, whereas the preliminary work was done by the Technical Groups, these assessments served as inputs that needed a thorough review and finalisation by impartial experts with domain knowledge in the concerned areas. On this basis, Advisory Panels were constituted by the CFSA comprising non-official experts drawn from within the country. These Advisory Panels, however, had for support some senior officials with requisite domain knowledge, but only as special invitees and not as members. The Advisory Panels made their assessments after a thorough debate and rigorous scrutiny of inputs provided by Technical Groups. This ensured an impartial assessment.

Third, for further strengthening the credibility of assessment, it was considered necessary that the Advisory Panels' assessments be peer reviewed by eminent external experts before finalisation of the panel

reports. The Advisory Panels considered the peer reviewers' comments and modified their assessments as appropriate. If they differed from peer reviewers, the reasons have been recorded. For a better exchange of views between the peer reviewers and the Advisory Panels, extensive conferences and seminars were held involving the respective peer reviewer, Advisory Panels and officials of the regulatory agencies at the highest levels.

The Advisory Panel reports, along with peer reviewers' comments, are being publicly disclosed on the Reserve Bank and Government websites. The CFSA drew up its own overview report at the final stage, drawing upon the assessments, findings, and the recommendations of the Advisory Panels.

Thirty-one experts from diverse fields were identified as members of the four Advisory Panels. In addition, senior officials from the Government, the Reserve Bank, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA) were also inducted as *ex officio* special invitees to the panels.

The four Advisory Panels were supported by four Technical Groups with the involvement of more than 100 officials drawn from various agencies. The areas covered by the four Advisory Panels were:

- Advisory Panel on Financial Stability Assessment and Stress Testing, covered macro-prudential analysis and stress testing of the financial sector (Chairman: Shri M.B.N. Rao, former Chairman and Managing Director, Canara Bank).
- Advisory Panel on Financial Regulation and Supervision, covered banking regulation and supervision, securities market regulation and insurance regulation standards (Chairman: Shri M.S.Verma, former Chairman, State Bank of India).
- Advisory Panel on Institutions and Market Structure, covered standards regarding bankruptcy laws, corporate governance, accounting and auditing and, payment and settlement systems (Chairman, Shri C.M. Vasudev, former Secretary, Department of Economic Affairs, Ministry of Finance, Government of India).
- Advisory Panel on Transparency Standards, covered standards pertaining to monetary and financial policies, fiscal transparency and data dissemination issues (Chairman: Shri Nitin Desai, former Under-Secretary-General, United Nations).

*Institutions/Agencies Involved*

Yet another area of strength in the current process of self-assessment has been the spirit of inter-regulatory co-operation and association of several other agencies in the process of assessment. Taking into account the legal, regulatory and supervisory architecture in India, the CFSA felt the need for involving and associating closely all the major regulatory

institutions, *viz.*, the Reserve Bank, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA). Depending upon the sectoral/functional distribution, several other regulatory and supervisory agencies in the financial system were also associated, besides involving concerned departments of the Central Government.

*Involvement of Peer Reviewers*

The CFSA identified 13 international experts and three Indian experts to peer review the relevant portions of the Panel reports in accordance with the reviewers' areas of expertise. The draft Advisory Panel Reports were forwarded to the respective peer reviewers for their comments. To discuss the comments and suggestions of the peer reviewers, two brainstorming sessions interfacing the peer reviewers with the Panel and CFSA members were also held in Mumbai in the form of a two-day seminar on June 13-14, 2008 and a day's conference on July 7, 2008. The views of the peer reviewers and the Advisory Panel's stance have been incorporated in the Panel Reports. Depending upon the stance of the Panel, the texts of the Panel Reports were appropriately modified by the Panels.

We would like to acknowledge the significant contributions made by the experts of the four Advisory Panels chaired by Shri M.B.N. Rao, former Chairman and Managing Director, Canara Bank, Shri M.S. Verma, former Chairman, State Bank of India, Shri C.M. Vasudev, former Secretary, Department of Economic Affairs, Ministry of Finance, Government of India and Shri Nitin Desai, former Under-Secretary-General, United Nations. The CFSA expresses its sincere gratitude to Dr. Y.V. Reddy, then Governor, the Reserve Bank, Shri M. Damodaran, former Chairman, SEBI, Shri C.B. Bhave, Chairman, SEBI, Shri C.S. Rao, former Chairman, IRDA and Shri J. Harinarayan, Chairman, IRDA for extending wholehearted support to the Panels and the CFSA in undertaking their tasks. We are grateful to note that, despite the pressing demands on their time, the external peer reviewers have sent in their very insightful comments, in an honorary capacity. The Secretariat to the CFSA and the Technical Groups comprising officials drawn from the Reserve Bank, the SEBI, the IRDA, Government and other agencies have done outstanding background work for the Advisory Panels and the Committee. We also acknowledge the valuable contribution made by Shri T.C.A. Srinivasa Raghavan who edited and helped in producing these volumes for publication and Dr. Renu Gupta and Dr. Janak

Raj for copy editing. A complete list of officials, non-officials, agencies associated and peer reviewers who contributed to this enormous task can be found as part of the Introductory Chapter to this Overview Report. The CFSA acknowledges their wholehearted and committed support. This whole exercise demonstrates the continuing commitment of Indian authorities to benefit from theory and practice, and the experiences of other countries, in our quest for global benchmarking of our financial sector standards.

The CFSA, while finalising its Overview Report, attempted to address issues arising out of the four Advisory Panel reports thematically into a set of key areas. As the Advisory Panels comprised independent non-official experts and their reports were peer reviewed by eminent external academics and policy-makers and are being transparently made public, their reports on a stand-alone basis deserve consideration for follow-up on their own merit. While the CFSA mostly endorsed the assessment, findings and recommendations of the Panels, it recognised at the same time that on certain aspects there were differing perspectives and stance taken by Panels on certain overlapping issues. Second, the CFSA also took into account the complexities of the current stage of economic and market development, including the Indian democratic polity, and has attempted to present a synthesised approach, whenever it viewed that issues were contestable. Third, while the membership of the CFSA along with the involvement of other regulators provides enormous comfort of ownership and commitment from authorities, the views of the Committee should for all practical purposes be treated nevertheless as independent and it is for the concerned authorities to chalk out an implementation plan for action.

The framework and work process, besides ensuring impartiality and credibility as brought out above, also carried with it certain other important benefits:

- First, the direct official involvement at different levels brought with it enormous responsibility, ownership and commitment.
- Second, it ensured constructive pragmatism while addressing, in particular, contestable issues. In the current context of several established conventions and practices being re-examined in the light of the ongoing global financial crisis, there is a need to approach reforms in the financial sector, particularly from the point of view of emerging markets that are more vulnerable than any other, with a sense of humility. The CFSA carried this burden throughout.
- Third, the close involvement of officials and non-official experts in conjunction with external peer reviewers – an entirely new dimension added for the first time – meant that the process itself proved to be an investment in human resources producing an outcome that sensitised the financial sector agents and the

internalised learning is expected to act as a stimulus for spearheading financial sector development and carrying the reform measures forward. No doubt, this has helped enhance the skill-sets within the financial sector, leading to significant capacity-building.

We would like to place on record our sincere and heartfelt appreciation of the valuable and painstaking contributions made by the Secretariat to the CFSA based in the Reserve Bank of India, headed by Shri K. Kanagasabapathy and supported by Dr. (Smt.) Mohua Roy, Shri Susobhan Sinha, Shri Sunil T. S. Nair, Dr. Saibal Ghosh, Shri D.Sathish Kumar, Shri Nishanth Gopinath, Shri Prabhat Gupta, Smt. P.K. Shahani, Shri A.B. Kulkarni, Shri R.J. Bhanse, Shri S.S. Jogale and Shri B.G. Koli. The Secretariat, besides organising the work of the CFSA, also co-ordinated the work relating to Technical Groups and Advisory Panels. The members of the Secretariat also actively associated themselves in preparing technical notes and background material at various stages and in organising conferences/ seminars and drafting the CFSA Report. Shri V.K. Sharma, Executive Director, Reserve Bank of India helped greatly in overseeing the Secretariat and making sure that all inputs were available from the different departments of the Reserve Bank. In addition, Shri Sharma made significant conceptual and technical contribution in areas like the assessment of Business Continuity Management, development of liquidity ratios to assess liquidity risks and related capital charge as also duration of equity as a measure of interest rate risk. Shri Anand Sinha, Executive Director, Reserve Bank of India also contributed in conceptualising the scenario analysis to assess the liquidity position of banks. The CFSA also places on record the co-ordination and help received from Shri Anuj Arora, Shri Vanlalramsanga and Smt. Aparna Sinha, Ministry of Finance, Government of India.

It is with pleasure and with a sense of utmost humility that the CFSA presents the results of assessment of the India's financial sector and a set of recommendations meant for the medium-term of about five years. The accent in this assessment is on transparency. Thus, where conflicting views have emerged among the Panels, the peer reviewers, and even among the members of the CFSA, they have been reported transparently. Regulation and development of the financial sector is a complex affair and there is room for constant debate and discussion, as shown particularly by the debate that is now being conducted in the wake of the ongoing global

financial crisis. The approach taken in this assessment is to provide general directions and excessive specificity has been eschewed.

The assesssment and recommendations comprise six volumes consisting of the Executive Summary, the Overview Report of the CFSA and the Reports of the four Advisory Panels on Financial Stability Assessment and Stress Testing, Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards. These volumes should be viewed as a package complementing one another.

The CFSA hopes that these volumes greatly enhance the understanding of the Indian financial sector among a wide readership, both in India and abroad. The CFSA would earnestly urge the Government of India, the Reserve Bank, SEBI, IRDA and other concerned market agents to promote wide dissemination and debate and initiate policy actions for improving the structural aspects of the Indian financial architecture.

Ashok Chawla
Co-Chairman and
Secretary, Department of Economic Affairs
Ministry of Finance
Government of India

Rakesh Mohan
Chairman and
Deputy Governor
Reserve Bank of India

March 20, 2009

## List of Acronyms

| | |
|---|---|
| AACS | As Applicable to Co-operative Societies |
| AASs | Auditing and Assurance Standards |
| ADR | American Depository Receipt |
| ADs | Authorised Dealers |
| AFS | Available for Sale |
| AGL | Aggregate Gap Limit |
| AGM | Annual General Meeting |
| AIG | American International Group |
| ALM | Asset-liability Management |
| AMA | Advanced Measurement Approach |
| AMBI | Association of Merchant Bankers of India |
| AMFI | Association of Mutual Funds in India |
| AML | Anti-money Laundering |
| ANMI | Association of NSE Members of India |
| APC | Auditing Practices Committee |
| APG | Asia/Pacific Group |
| AS | Accounting Standards |
| ASB | Accounting Standards Board |
| ASSOCHAM | Associated Chambers of Commerce and Industry of India |
| ATM | Automated Teller Machine |
| BC | Business Correspondent |
| BCBS | Basel Committee on Banking Supervision |
| BCM | Business Continuity Management |
| BCP | Business Continuity Planning |
| BCPs | Basel Core Principles |
| BCSBI | Banking Codes and Standards Board of India |
| BIFR | Board for Industrial and Financial Reconstruction |
| BIS | Bank for International Settlements |
| BOISL | Bank of India Shareholding Limited |
| BPLR | Benchmark Prime Lending Rate |
| BPO | Business Process Outsourcing |
| BPSS | Board for Regulation and Supervision of Payment and Settlement Systems |
| BR Act | Banking Regulation Act |
| BSE | Bombay Stock Exchange |
| CAD | Current Account Deficit |
| CAG | Comptroller and Auditor General |
| CAGR | Compounded Annual Growth Rate |
| CAL | Capital Account Liberalisation |
| CASA | Current and Savings Account |
| CBLO | Collateralised Borrowing and Lending Obligation |
| CCIL | Clearing Corporation of India Ltd. |
| CCPs | Central Counterparties |
| CD | Certificate of Deposit |
| CDD | Customer Due Diligence |
| CDS | Credit Default Swap |
| CDSL | Central Depository Services (India) Ltd. |
| CEO | Chief Executive Officer |
| CFP | Contingency Funding Plan |
| CFSA | Committee on Financial Sector Assessment |
| CFT | Combating the Financing of Terrorism |

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| CIBIL | Credit Information Bureau of India Ltd. |
| CII | Confederation of Indian Industry |
| CIP | Central Integrated Platform |
| CIS | Collective Investment Scheme |
| CLS | Continuous Linked Settlement |
| CME | Capital Market Exposure |
| CP | Commercial Paper |
| CPI | Consumer Price Index |
| CPI-AL | Consumer Price Index - Agricultural Labourers |
| CPI-IW | Consumer Price Index - Industrial Workers |
| CPI-RL | Consumer Price Index - Rural Labourers |
| CPI-UNME | Consumer Price Index - Urban Non-manual Employees |
| CPSS | Committee on Payment and Settlement Systems |
| CRA | Credit Rating Agencies |
| CRAR | Capital to Risk-weighted Assets Ratio |
| CRISIL | Credit Rating Information Services of India Ltd. |
| CRR | Cash Reserve Ratio |
| CRT | Credit Risk Transfer |
| CSC | Clients of Special Category |
| CSGL | Constitutents Subsidiary General Ledger |
| CSO | Central Statistical Organisation |
| CTR | Cash Transactions Report |
| CVC | Central Vigilance Commission |
| DBOD | Department of Banking Operations and Development |
| DCCBs | District Central Co-operative Banks |
| DEA | Data Envelopment Analysis |
| DFIs | Development Financial Institutions |
| DICGC | Deposit Insurance and Credit Guarantee Corporation |
| DIF | Deposit Insurance Fund |
| DIP | Disclosure and Investor Protection |
| DIPP | Department of Industrial Policy and Promotion |
| DMO | Debt Management Office |
| DoE | Duration of Equity |
| DP | Depository Participant |
| DQAF | Data Quality Assessment Framework |
| DR | Disaster Recovery |
| DRAT | Debt Recovery Appellate Tribunal |
| DRR | Designated Reserve Ratio |
| DRT | Debt Recovery Tribunal |
| DvP | Delivery versus Payment |
| EaR | Earnings at Risk |
| ECS | Electronic Clearing System |
| EFT | Electronic Funds Transfer |
| EGM | Extraordinary General Meeting |
| ELSS | Equity-linked Savings Scheme |
| EMEs | Emerging Market Economies |
| ESOP | Employee Stock Option Plan |
| EWS | Economically Weaker Sections |
| FATF | Financial Action Task Force |
| FBs | Foreign Banks |
| FCAC | Fuller Capital Account Convertibility |
| FCs | Financial Conglomerates |
| FDI | Foreign Direct Investment |
| FEDAI | Foreign Exchange Dealers' Association of India |
| FEMA | Foreign Exchange Management Act |

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| FERA | Foreign Exchange Regulation Act |
| FFMCs | Full-fledged Money Changers |
| FICCI | Federation of Indian Chamber of Commerce and Industry |
| FII | Foreign Institutional Investor |
| FIMMDA | Fixed Income Money Market and Derivatives Association of India |
| FIU | Financial Intelligence Unit |
| FOMC | Federal Open Market Committee |
| FPI | Foreign Portfolio Investment |
| FPSBI | Financial Planning Standards Board of India |
| FRB | Federal Reserve Bank |
| FRBM | Fiscal Responsibility and Budget Management |
| FRRB | Financial Reporting Review Board |
| FSA | Financial Services Authority |
| FSAP | Financial Sector Assessment Program |
| FSF | Financial Stability Forum |
| FSIs | Financial Soundness Indicators |
| FSRB | FATF-style Regional Body |
| GAAP | Generally Accepted Accounting Principles |
| GASAB | Government Accounting Standards Advisory Board |
| GB | Gramin Bank |
| GCC | General Credit Card |
| GDP | Gross Domestic Product |
| GDR | Global Depository Receipt |
| GFD | Gross Fiscal Deficit |
| GFS | Government Finance Statistics |
| GFSM | Government Finance Statistics Manual |
| GLB | Gramm-Leach-Bliley |
| GS | Government Securities |
| HFCs | Housing Finance Companies |
| HFT | Held for Trading |
| HHI | Herfindahl Index |
| HLCCFM | High Level Co-ordination Committee on Financial Markets |
| HR | Human Resources |
| HTM | Held to Maturity |
| IAASB | International Auditing and Assurance Standards Board |
| IADI | Insurance Association of Deposit Insurers |
| IAIS | International Association of Insurance Supervisors |
| IAPC | International Auditing Practices Committee |
| IAS | International Accounting Standards |
| IASB | International Accounting Standards Board |
| IBA | Indian Banks' Association |
| ICAAP | International Capital Adequacy Assessment Process |
| ICAI | Institute of Chartered Accountants of India |
| ICICI | Industrial Credit and Investment Corporation of India Ltd. |
| ICOR | Incremental Capital-Output Ratio |
| ICPs | Insurance Core Principles |
| ICSI | Institute of Companies Secretaries of India |
| ICWAI | Institute of Cost and Works Accountants of India |
| IDL | Intra-day Liquidity |
| IFCI | Industrial Finance Corporation of India Ltd. |
| IFRIC | International Financial Reporting Interpretations Committee |

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| IFRS | International Financial Reporting Standards |
| IGFRS | Indian Government Financial Reporting Standards |
| IMF | International Monetary Fund |
| IMSS | Integrated Market Surveillance System |
| IOSCO | International Organisation of Securities Commission |
| IPOs | Initial Public Offers |
| IR | Industrial Relations |
| IRB | Internal Ratings-based Approach |
| IRDA | Insurance Regulatory and Development Authority |
| IRS | Interest Rate Swaps |
| ISA | International Standards on Auditing |
| JLG | Joint Liability Group |
| KCC | Kisan Credit Card |
| KYC | Know Your Customer |
| LABs | Local Area Banks |
| LAF | Liquidity Adjustment Facility |
| LDC | Less Developed Countries |
| LIBOR | London Inter-bank Offer Rate |
| LIC | Life Insurance Corporation |
| LIG | Low-income Group |
| LoC | Line of Credit |
| LoLR | Lender of Last Resort |
| LtV | Loan to Value |
| MCA | Ministry of Corporate Affairs |
| MFI | Micro-finance Institutions |
| MoU | Memorandum of Understanding |
| MPC | Monetary Policy Committee |
| MRTP | Monopolies and Restrictive Trade Practices |
| MSS | Market Stabilisation Scheme |
| MTM | Mark-to-market |

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| NABARD | National Bank for Agriculture and Rural Development |
| NACAS | National Advisory Committee on Accounting Standards |
| NASD | National Association of Securities Dealers |
| NASDAQ | National Association of Securities Dealers Automated Quotations |
| NBFC-D | Deposits taking Non-banking Financial Companies |
| NBFC-ND | Non-deposit taking Non-banking Financial Companies |
| NBFC-ND-SI | Non-deposit taking Systemically Important Non-banking Financial Companies |
| NBFCs | Non-banking Financial Companies |
| NBO | National Building Organisation |
| NCLT | National Company Law Tribunal |
| NDFs | Non-deliverable Forwards |
| NDS | Negotiated Dealing System |
| NDS-OM | Negotiated Dealing System - Order Matching |
| NEFT | National Electronic Fund Transfer |
| NGO | Non-governmental Organisation |
| NHB | National Housing Bank |
| NII | Net Interest Income |
| NPAs | Non-performing Assets |
| NPBs | New Private Sector Banks |
| NSC | National Statistical Commission |
| NSCCL | National Securities Clearing Corporation Ltd. |
| NSDL | National Securities Depository Ltd. |
| NSE | National Stock Exchange |
| NSSO | National Sample Survey Organisation |

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| OBS | Off-balance Sheet |
| OECD | Organisation of Economic Co-operation and Development |
| OFIs | Other Financial Institutions |
| OIS | Overnight Index Swap |
| OMO | Open Market Operations |
| OPBs | Old Private Sector Banks |
| OTC | Over-the-Counter |
| OTD | Originate to Distribute |
| P/E | Price to Earnings |
| PACS | Primary Agricultural Credit Societies |
| PCA | Prompt Corrective Action |
| PCAOB | Public Company Accounting Oversight Board |
| PDAI | Primary Dealers Association of India |
| PDO | Public Debt Office |
| PDs | Primary Dealers |
| PEP | Politically-exposed Persons |
| PFRDA | Pension Fund Regulatory and Development Authority |
| PMLA | Prevention of Money-laundering Act |
| PMRY | Prime Minister's Rozgar Yojana |
| PNs | Participatory Notes |
| PPP | Public-private Partnership |
| PSBR | Public Sector Borrowing Requirement |
| PSBs | Public Sector Banks |
| QIB | Qualified Institutional Buyers |
| QRB | Quality Review Board |
| RARoC | Risk-adjusted Return on Capital |
| RBC | Risk-based Capital |
| RBS | Risk-based Supervision |
| RCS | Registrar of Co-operative Societies |
| RDDBFI | Recovery of Debts Due to Banks and Financial Institutions |
| RNBCs | Residuary Non-banking Companies |
| RoA | Return on Assets |
| RoE | Return on Equity |
| ROSC | Report on Observance of Standards and Codes |
| RRBs | Regional Rural Banks |
| RSE | Recognised Stock Exchange |
| RTGS | Real Time Gross Settlement |
| SARFAESI | Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act |
| SBI | State Bank of India |
| SCODA | SEBI Committee on Disclosures and Accounting Standards |
| SCRA | Securities Contracts (Regulation) Act |
| SDDS | Special Data Dissemination Standard |
| SEBI | Securities and Exchange Board of India |
| SEC | Securities and Exchange Commission |
| SFCs | State Financial Corporations |
| SGL | Subsidiary General Ledger |
| SHG | Self-help Group |
| SICA | Sick Industrial Companies (Special Provisions) Act |
| SIDBI | Small Industries Development Bank of India |
| SIPS | Systemically Important Payment Systems |
| SIVs | Structured Investment Vehicles |
| SJSRY | Swarna Jayanti Shahari Rojgar Yojana |
| SLBC | State-level Bankers' Committee |

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| SLR | Statutory Liquidity Ratio |
| SMEs | Small and Medium Enterprises |
| SPV | Special Purpose Vehicle |
| SRA | Statutory-regulatory Authority |
| SRI | Socially Responsible Investing |
| SROs | Self-regulatory Organisations |
| SSI | Small Scale Industry |
| SSS | Securities Settlement Systems |
| StCBs | State Co-operative Banks |
| STP | Straight-through Processing |
| STR | Suspicious Transactions Report |
| STRIPS | Separate Trading of Registered Interest and Principal of Securities |
| STT | Securities Transaction Tax |
| SUCBs | Scheduled Urban Co-operative Banks |
| TACMP | Technical Advisory Committee on Monetary Policy |
| TAFCUB | Task Force for Urban Co-operative Banks |
| TAG | Technical Advisory Group |
| TDS | Tax Deducted at Source |
| UAPA | Unlawful Activities Prevention Act |
| UCBs | Urban Co-operative Banks |
| ULIPs | Unit-linked Insurance Plans |
| UNCITRAL | United Nations Commission on International Trade Law |
| URRBCH | Uniform Regulations and Rules for Bankers' Clearing Houses |
| VaR | Value-at-Risk |
| WI | When issued |
| WOS | Wholly-owned Subsidiaries |
| WPI | Wholesale Price Index |
| WTO | World Trade Organisation |

## Chapter I

# Introduction

The Government of India in consultation with the Reserve Bank of India constituted the Committee on Financial Sector Assessment (CFSA) in September 2006 with a mandate to undertake a comprehensive assessment of the India's financial sector focusing upon stability and development, including therein detailed assessments of its status and compliance with various international financial standards and codes. The CFSA was chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India; the Co-Chairmen were Shri Ashok Jha, Dr. D. Subbarao and Shri Ashok Chawla. The Committee also had officials from the Government of India as its members (Annex I).

The CFSA had the following terms of reference:

- To identify appropriate areas, techniques and methodologies in the *Handbook on Financial Sector Assessment* brought out by the International Monetary Fund/World Bank, and in other pertinent documents for financial sector assessment relevant in the current and evolving context of the Indian financial sector;
- To apply relevant methodologies and techniques adapted to the Indian system and attempt a comprehensive and objective assessment of Indian financial sector, including its development, efficiency, competitiveness and prudential aspects;
- To analyse specific development and stability issues relevant to India; and
- To make available its report(s) through the Reserve Bank of India/ Government of India websites.

The approach, broad framework and work procedures were approved in the first meeting of the Committee. Following this, contact points were established with other major regulators as also external agencies like the International Monetary Fund (IMF) and the World Bank for co-ordination of the work. The IMF/World Bank also provided relevant templates for assessment of various standards and codes, which have been appropriately utilised in the Committee's work. The CFSA held a series of meetings to review the progress, take stock and guide the work. The CFSA submitted an interim report to the then Hon'ble Finance Minister, Shri P Chidambaram and to the then Governor, Reserve Bank of India, Dr. Y V Reddy on August 2, 2007. The CFSA finalised its

Overview report in its meeting held on December 20, 2008. The CFSA held 11 meetings between October 2006 and December 2008 before finalising its report.

## 1.1 Approach and Framework for the Assessment

The CFSA followed an approach to self-assessment based on three mutually-reinforcing pillars, *viz.,* Pillar I: financial stability assessment and stress testing, essentially in the nature of stability assessment which utilises analytical tools for quantifying the risks and vulnerabilities in the financial sector; Pillar II: legal, infrastructural and market development issues; and Pillar III: comprehensive assessment of the status and implementation of international financial standards and codes, taking into account updates since the last FSAP/ ROSC and earlier self-assessments and the specific features of the Indian financial system. The second pillar draws inputs from the assessment in the first and third pillars focusing on developmental issues for further strengthening the financial sector.

In order to assist the CFSA in its process of assessment, four Technical Groups mainly comprising officials from relevant organisations who, based on their functional domain knowledge, provided technical notes and background material for assessments of their respective subject areas. The preliminary assessments of standards were also carried out by them. These Groups focused on (a) Financial Stability Assessment and Stress Testing, (b) Financial Regulation and Supervision, (c) Institutions and Market Structure and (d) Transparency Standards, respectively. The CFSA also constituted four Advisory Panels comprising non-official experts in the respective areas and, wherever necessary, was supported by senior officials in the form of Special Invitees, with requisite domain expertise. These Panels provided an impartial review of assessments made by the Technical Groups and prepared their draft reports.

With a view to further enhancing the credibility of the self-assessment, the CFSA arranged for the draft reports of the Advisory Panels to be peer reviewed by external experts. The Advisory Panel reports were finalised after taking into account the peer reviewers' comments and their interactions with peer reviewers in conferences/seminars.

The CFSA finally drew up its Overview report based on the Advisory Panel reports.

A schematic diagram of the framework is provided in Annex II.

## 1.2 Work Process

### 1.2.1. Constitution of Advisory Panels and Technical Groups

Twenty six experts from diverse fields were identified as members of the four Advisory Panels. In addition, senior officials from the Government, the

Reserve Bank, SEBI and IRDA were also inducted as *ex officio* special invitees to the panels. The complete list of all members and special invitees to the Advisory Panels is given in Annex III.

The four Advisory Panels were supported by four Technical Groups with the involvement of more than 100 officials drawn from various agencies. The details of membership and participation in various Technical Groups are provided in Annex IV.

### 1.2.2 Co-ordination with Multilateral Agencies

The IMF and the World Bank have been evincing keen interest in CFSA's work and extending their support. At a very early stage, the Chairman held meetings with World Bank/IMF officials, who offered to help the Committee identify a list of experts, identify contact persons in the World Bank/IMF to liaise with the CFSA, share FSAP templates and identify FSAP documents for reference by the Committee. Also, the International Association of Insurance Supervisors (IAIS) assisted IRDA in suggesting the names of peer reviewers and the International Organisation of Securities Commission (IOSCO) provided SEBI with the necessary IOSCO templates for the assessments. The CFSA gratefully acknowledges the assistance of these institutions.

### 1.2.3 Institutions/Agencies Involved

Taking into account the legal, regulatory and supervisory architecture in India, the CFSA involved and associated closely with all three major regulatory institutions, *viz.*, the Reserve Bank, SEBI and IRDA. Depending on the sectoral/ functional distribution, several other agencies in the financial system were associated, besides involving concerned departments of the Central Government. A complete list of the agencies involved in the assessment exercise is given in Annex V.

### 1.2.4 Involvement of Peer Reviewers

The CFSA identified 14 international experts and three Indian experts to peer review the relevant portions of the Panel reports in accordance with the reviewers' areas of expertise. The list of peer reviewers is given in Annex VI.

### 1.2.5 The Secretariat

To further the technical work and for administrative co-ordination between all the involved institutions and the study of relevant documents to prepare background material for the Technical Groups and Advisory Panels, a Secretariat was constituted in the Reserve Bank, Monetary Policy Department (Please see Annex VII for the composition of the Secretariat).

### 1.2.6 Detailed Work Procedures under each of the Three Pillars

*Pillar I: Financial Stability Assessment and Stress Testing*

The Advisory Panel on Financial Stability Assessment and Stress Testing covered areas related to the macro-economy, financial markets, financial infrastructure and financial institutions. The Panel constituted three sub-groups: relating to financial stability, stress testing and business continuity management

(BCM). The sub-group on financial stability deliberated and identified the soundness and vulnerabilities in the Indian financial system. In addition to the Reserve Bank, SEBI and IRDA, it has also taken on board the perspectives of agencies like the National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB), Indian Banks' Association (IBA), Investment Information and Credit Rating Agency of India Limited (ICRA), Credit Rating Information Services India Ltd. (CRISIL), KPMG and Clearing Corporation of India Ltd. (CCIL), and incorporated the same as part of their report.

The sub-group on stress testing adopted a plausible 'bottom-up' approach to stress testing, using various scenarios. Single factor stress tests for the commercial banking sector covering credit risk, market/interest rate risk and liquidity risk were carried out. The Group also undertook quantitative stress tests and qualitative analysis in respect of certain financial variables and liquidity infrastructure.

The sub-group on business continuity management (BCM) assessed the status of business continuity planning (BCP) and disaster recovery management. A questionnaire suitably expanding on the *High Level Principles for Business Continuity Management* developed by the BIS Joint Forum in August 2006 was circulated among identified banks as also CCIL. In addition, the Reserve Bank also undertook an assessment of its own BCM systems.

IRDA prepared a separate stability analysis for institutions within their regulatory purview including financial stability and stress testing issues relating to the insurance sector.

*Pillar III: Assessment of Implementation of International Financial Standards and Codes*

The implementation of/compliance with 14 international financial standards was evaluated under the comprehensive assessment exercise. The CFSA decided that in respect of AML-CFT standards a review of assessment undertaken by the Asia Pacific Group (APG) in 2005 would be incorporated in the Overview Report. For operational convenience, these standards were divided into three compact groups, *viz.,* Regulation and Supervision, Institutions and Market Structure, and Transparency Standards.

In addition to the assessment of adherence to Basel *Core Principles* regarding supervision of commercial banks, the Advisory Panel on Financial Regulation and Supervision also conducted assessment of the adherence to *Core Principles* as relevant in other closely-related segments such as the urban co-operative banking sector, rural credit institutions and non-banking and housing finance companies. Likewise, an assessment of the observance of International

Organisation of Securities Commissions' (IOSCO) *Core Principles* in the securities market was undertaken by SEBI. In addition, an assessment of the implementation of IOSCO Principles as relevant to government securities market and in respect of foreign exchange and money markets was also undertaken for the first time, involving the concerned departments in the Reserve Bank. The adherence to *Core Principles* of the International Association of Insurance Supervisors (IAIS) was assessed by IRDA.

The Advisory Panel on Institutions and Market Structure undertook a detailed assessment of market infrastructure focusing on liquidity management, accounting and auditing, corporate governance, payment and settlement systems and legal infrastructure.

In respect of payment and settlement systems, the coverage was extended to an assessment of their adherence to the *Core Principles for Systemically Important Payment Systems* in respect of Real Time Gross Settlement System (RTGS) and High Value Clearing System; *Recommendations for Securities Settlement Systems* in respect of settlement of government securities and equities markets; *Recommendations for Central Counterparties* applicable to government securities, foreign exchange market and Collateralised Borrowing and Lending Obligation (CBLO) and corporate bonds and equities. The assessment of adherence to the Organisation for Economic Co-operation and Development (OECD) *Principles of Corporate Governance* in respect of listed and unlisted companies was carried out jointly by SEBI and the Ministry of Corporate Affairs, Government of India. The assessment of convergence of Indian accounting and auditing standards put out by ICAI to the international accounting and auditing standards was assessed by ICAI, AASB and the Reserve Bank. The adherence to the World Bank's *Principles for Effective Insolvency and Creditor Rights Systems* was assessed by the Reserve Bank and the Ministry of Corporate Affairs.

The Advisory Panel on Transparency Standards assessed the adherence to relevant IMF standards, *viz., Code of Good Practices on Transparency in Monetary and Financial Policies, Code of Good Practices on Fiscal Transparency, Special Data Dissemination Standards* and *Data Quality Assessment Framework.* While the assessment of transparency in monetary policy pertained to the Reserve Bank, transparency in financial policies included the three agencies, *viz.*, the Reserve Bank, SEBI and IRDA. Fiscal transparency assessment involved a response to a detailed questionnaire to relevant government departments, State Governments and the Reserve Bank to identify the gaps in fiscal transparency. For the first time, the Advisory Panel attempted a separate assessment of fiscal transparency pertaining to State Governments. Data dissemination was assessed with emphasis on dimensions of quality of the data.

*Pillar II: Development Issues*

The assessments and findings under Pillar I and III led to identification of several areas for convergence with international best practices as also certain issues and concerns in regard to further strengthening and developing the

financial sector. The Advisory Panels have made appropriate recommendations as part of their assessments of financial institutions, financial markets and financial infrastructure.

## 1.3 Scheme of the Report

Drawing on inputs from the four Advisory Panel Reports, the CFSA first addresses the issues relating to the macro-economic environment and identifies certain potential areas of vulnerability at the current juncture. The financial sector assessment part is covered in three major parts, *viz.,* financial institutions, financial markets and financial infrastructure. All standards assessments, excepting transparency issues, have also been integrated appropriately into these assessments. The CFSA addresses these areas broadly encompassing their performance and resilience to certain shocks, and identifying areas for further strengthening and development. Transparency issues are covered in a separate chapter by the CFSA. The CFSA considered the views of the Panels as also those of peer reviewers and recorded their own stance in the respective chapters.

Based on the above approach, the Committee's Overview Report is divided into eight chapters. Following this chapter, Chapter 2 covers aspects relating to the macro-economic environment including an assessment of potential areas of vulnerability; Chapter 3, after providing an overview of the financial structure, covers in detail the stability aspects of financial institutions including structure and performance, resilience, relevant observance of standards and issues and recommendations for further development; Chapter 4 covers assessment of financial markets which includes structure and performance, observance of relevant standards and issues and recommendations for further market development; Chapter 5 covers financial infrastructure which encompasses a host of dimensions, *viz.*, regulatory structure, liquidity management, accounting and auditing, payment and settlement systems, legal infrastructure including bankruptcy laws, business continuity management, corporate governance issues and safety net issues focusing on deposit insurance. The concerned sections also address issues and recommendations for strengthening the financial infrastructure. Chapter 6 covers transparency issues relating to monetary policy, financial policies, fiscal policy and data dissemination, and Chapter 7 covers broader development issues in the socio-economic context, mainly relating to customer service and financial inclusion.

The concluding Chapter provides a summary of observations and recommendations with appropriate cross-references to earlier chapters.

# Annex I

## Composition of the Committee on Financial Sector Assessment

**Chairman**

Dr. Rakesh Mohan
Deputy Governor
Reserve Bank of India

**Co-Chairman**

Shri Ashok Chawla
Secretary
Department of Economic Affairs
Ministry of Finance
Government of India
(from September 6, 2008)

Dr. D. Subbarao
Former Finance Secretary
Government of India
(July 16, 2007 - September 5, 2008)

Shri Ashok Jha
Former Finance Secretary
Government of India
(September 13, 2006 - July 15, 2007)

**Members**

Shri Arun Ramanathan
Finance Secretary
Government of India
(from February 4, 2008)

Shri Vinod Rai
Former Secretary
Department of Financial Services
Ministry of Finance
Government of India
(January 11, 2007 - February 3, 2008)

Dr. Arvind Virmani
Chief Economic Adviser
Department of Economic Affairs
Ministry of Finance
Government of India

Dr. Alok Sheel
Joint Secretary (Fund-Bank)
Department of Economic Affairs
Ministry of Finance
Government of India
(from October 23, 2008)

Shri Madhusudan Prasad
Joint Secretary (Fund-Bank)
Department of Economic Affairs
Ministry of Finance
Government of India
(September 13, 2006 - October 22, 2008)

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

### Committee on Financial Sector Assessment

Building up resilient, well-regulated financial systems is essential for macroeconomic and financial stability. This is being increasingly recognised as an integral part of financial sector reforms in India. Following the initiation of the Financial Sector Assessment Programme (FSAP) in 1999 by the World Bank and the International Monetary Fund in the aftermath of the Asian financial crisis, and their experience in the conduct of assessment in member countries, the two institutions have jointly brought out in September 2005, a comprehensive Handbook on Financial Sector Assessment. The Handbook is designed for use in financial sector assessment, whether conducted by country authorities themselves or by World Bank and IMF teams. The Handbook, available to the public, is intended to serve as an authoritative source on the objectives, analytical framework, and methodologies of financial sector assessment as well as a comprehensive reference book on the techniques of such assessments.

2. It may be recalled that India, besides being one of the earliest member countries participating voluntarily in the FSAP assessment, has been a forerunner in comprehensive self-assessment of various international financial standards and codes. The Reserve Bank has also released a Synthesis Report in May 2002 and a Progress Report in January 2005. The experience has thus far been very encouraging and the financial sector reforms have progressed well in recent years, enhancing the soundness of the financial system and promoting financial stability.

3. Consistent with this approach, it would be appropriate and expedient for India to undertake a self-assessment of financial sector stability and development, using the new Handbook as the base as also any other pertinent documents for financial sector assessment. Accordingly, the Government of India has decided, in consultation with the Reserve Bank of India to constitute a 'Committee on Financial Sector Assessment', with the following terms of reference:

(i) To identify the appropriate areas, techniques and methodologies in the Handbook and also in any other pertinent documents for financial sector assessment relevant in the current and evolving context of the Indian financial sector;

(ii) To apply relevant methodologies and techniques adapted to Indian system and attempt a comprehensive and objective assessment of Indian financial sector, including its development, efficiency, competitiveness and prudential aspects;

(iii) To analyse specific development and stability issues as relevant to India; and

(iv) To make available its report(s) through RBI/GoI websites.

4. The Committee may co-opt members depending upon the subject area of assessment under consideration and may also constitute Technical/ Advisory groups to study and report on specific areas of assessment.

5. The Committee will be chaired by Dr.Rakesh Mohan, Deputy Governor, Reserve Bank of India, with Shri Ashok Jha, Secretary (Economic Affairs) as Co-Chairman. Dr.Ashok Lahiri, Chief Economic Adviser and Shri Madhusudan Prasad, Joint Secretary (Fund-Bank), Government of India will be its members. The Secretariat will be provided by the Reserve Bank of India.

6. The Committee will review its own status and report the progress to the Government of India/Reserve Bank of India in six months from commencement of its work.

(Y.V. Reddy)

Mumbai - 400 001.
September 13, 2006

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

### Committee on Financial Sector Assessment

In partial modification of the memorandum dated September 13, 2006 regarding constitution of the Committee on Financial Sector Assessment, it has been decided to include Shri Vinod Rai, Secretary (Financial Sector), Government of India and Dr. Arvind Virmani, Principal Adviser, Planning Commission, into the Committee. Accordingly, the composition of the reconstituted Committee on Financial Sector Assessment is as follows:

| | | | |
|---|---|---|---|
| Dr. Rakesh Mohan<br>Deputy Governor<br>Reserve Bank of India | Chairman | Shri Ashok Jha<br>Finance Secretary<br>Government of India | Co-Chairman |
| Shri Vinod Rai<br>Secretary (Financial Sector)<br>Government of India | Member | | |
| Dr. Arvind Virmani<br>Principal Adviser<br>Planning Commission | Member | | |
| Shri Madhusudan Prasad<br>Joint Secretary (Fund-Bank)<br>Government of India | Member | | |

(Y.V. Reddy)

Mumbai - 400 001.
January 11, 2007

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

## Committee on Financial Sector Assessment

In partial modification of the memorandum dated January 11, 2007 it has been decided to appoint Dr. D Subbarao, Finance Secretary, Government of India as the Co-chairman of the Committee on Financial Sector Assessment on retirement of Shri Ashok Jha, the earlier Finance Secretary and Co-chairman of the Committee. Accordingly, the composition of the reconstituted Committee on Financial Sector Assessment is as follows:

| | | | |
|---|---|---|---|
| Dr. Rakesh Mohan<br>Deputy Governor<br>Reserve Bank of India | Chairman | Dr. D Subbarao<br>Finance Secretary<br>Government of India | Co-Chairman |
| Shri Vinod Rai<br>Secretary (Financial Sector)<br>Government of India | Member | | |
| Dr. Arvind Virmani<br>Principal Adviser<br>Planning Commission | Member | | |
| Shri Madhusudan Prasad<br>Joint Secretary (Fund-Bank)<br>Government of India | Member | | |

(Y.V. Reddy)

Mumbai - 400 001.
July 16, 2007

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

### Committee on Financial Sector Assessment

In partial modification of the memorandum dated July 16, 2007 it has been decided to co-opt Shri Arun Ramanathan, Secretary (Financial Sector), Government of India as a member of the Committee on Financial Sector Assessment in place of Shri Vinod Rai, former Secretary (Financial Sector), Government of India, consequent to Shri Rai's appointment as the Comptroller and Auditor General of India. Accordingly, the composition of the reconstituted Committee on Financial Sector Assessment is as follows:

| | | | |
|---|---|---|---|
| Dr. Rakesh Mohan<br>Deputy Governor<br>Reserve Bank of India | Chairman | Dr. D Subbarao<br>Finance Secretary<br>Government of India | Co-Chairman |
| Shri Arun Ramanathan<br>Secretary (Financial Sector)<br>Government of India | Member | | |
| Dr. Arvind Virmani<br>Chief Economic Adviser<br>Government of India | Member | | |
| Shri Madhusudan Prasad<br>Joint Secretary (Fund-Bank)<br>Government of India | Member | | |

(Y.V. Reddy)

Mumbai - 400 001.
February 4, 2008

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

### Committee on Financial Sector Assessment

In partial modification of the memorandum dated February 4, 2008 it has been decided to co-opt Shri Ashok Chawla, Secretary (Economic Affairs), Department of Economic Affairs, Government of India as Co-chair of the Committee on Financial Sector Assessment in place of Dr. D. Subbarao, former Finance Secretary, Government of India, consequent to Dr.D.Subbarao's appointment as the Governor, Reserve Bank of India. Accordingly, the composition of the reconstituted Committee on Financial Sector Assessment is as follows:

| | | | |
|---|---|---|---|
| Dr. Rakesh Mohan<br>Deputy Governor<br>Reserve Bank of India | Chairman | Shri Ashok Chawla<br>Secretary<br>(Economic Affairs)<br>Government of<br>India | Co-Chairman |
| Shri Arun Ramanathan<br>Secretary (Financial Sector)<br>Government of India | Member | | |
| Dr. Arvind Virmani<br>Chief Economic Adviser<br>Government of India | Member | | |
| Shri Madhusudan Prasad<br>Joint Secretary (Fund-Bank)<br>Government of India | Member | | |

(D.Subbarao)

Mumbai - 400 001.
October 1, 2008

Governor

Reserve Bank of India
Central Office
Mumbai - 400 001

## MEMORANDUM

### Committee on Financial Sector Assessment

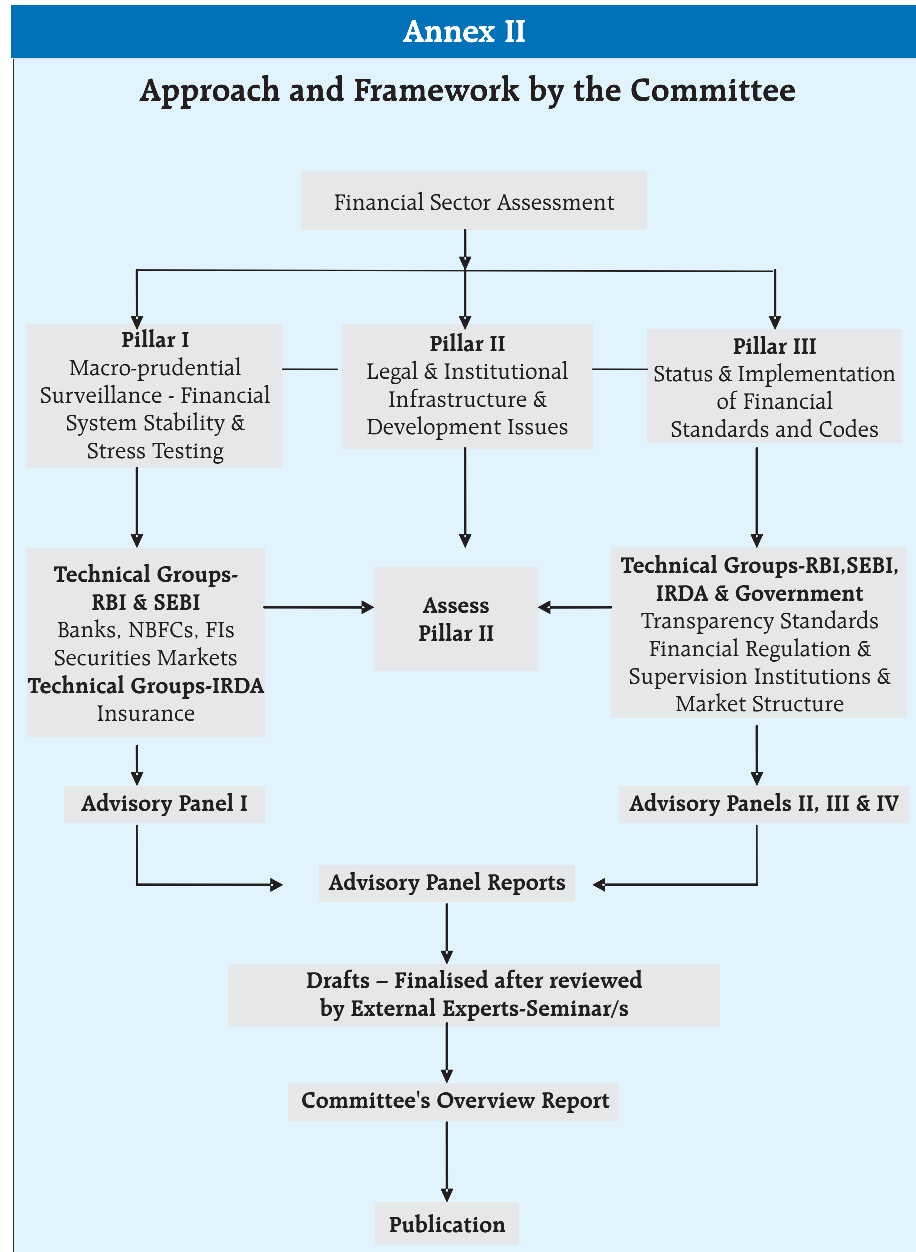
In partial modification of the memorandum dated October 1, 2008 it has been decided to appoint Shri Alok Sheel, Joint Secretary (Fund-Bank), Government of India as a member of the Committee on Financial Sector Assessment in place of Shri Madhusudan Prasad who has been transferred from the post of Joint Secretary (Fund-Bank). Accordingly, the composition of the reconstituted Committee on Financial Sector Assessment is as follows:

| | | | |
|---|---|---|---|
| Dr. Rakesh Mohan<br>Deputy Governor<br>Reserve Bank of India | Chairman | Shri Ashok Chawla<br>Secretary<br>(Economic Affairs)<br>Government of<br>India | Co-Chairman |
| Shri Arun Ramanathan<br>Finance Secretary<br>Government of India | Member | | |
| Dr. Arvind Virmani<br>Chief Economic Adviser<br>Government of India | Member | | |
| Shri Alok Sheel<br>Joint Secretary (Fund-Bank)<br>Government of India | Member | | |

(D.Subbarao)

Mumbai - 400 001.
November 26, 2008

## Annex II



## Annex III

### Advisory Panel Members and Special Invitees

| Name | Designation/Institution | |
|---|---|---|
| **1. Financial Stability Assessment and Stress Testing** | | |
| Shri M.B.N.Rao | Chairman and Managing Director, Canara Bank | Chairman |
| Dr. Rajiv B. Lall | Managing Director and Chief Executive Officer, Infrastructure Development Finance Company Ltd. | Member |
| Dr. T.T.Ram Mohan | Professor, Indian Institute of Management, Ahmedabad | Member |
| Shri Ravi Mohan | Managing Director and Region Head, Standard & Poor's, South Asia | Member |
| Shri Ashok Soota | Chairman and Managing Director, MindTree Consulting Ltd. | Member |
| Shri Pavan Sukhdev | Head of Global Markets, Deutsche Bank | Member |
| **Special Invitees** | | |
| Shri V.K.Sharma | Executive Director, Reserve Bank of India | |
| Dr. R. Kannan | Member (Actuary), Insurance Regulatory and Development Authority | |
| Shri G. C. Chaturvedi | Joint Secretary (Banking and Insurance), | |
| Dr. K. P. Krishnan | Joint Secretary (Capital Markets), Government of India | |
| Shri Amitabh Verma | Joint Secretary (Banking Operations), Government of India | |
| Dr. Sanjeevan Kapshe | Officer on Special Duty, Securities and Exchange Board of India | |

| 2. Financial Regulation and Supervision | | |
|---|---|---|
| Shri M. S. Verma | Former Chairman, State Bank of India | Chairman |
| Shri Nimesh Kampani | Chairman, JM Financial Consultants Pvt. Ltd. | Member |
| Shri Uday Kotak | Executive Vice-Chairman and Managing Director, Kotak Mahindra Bank Ltd. | Member |
| Shri Aman Mehta | Former Chief Executive Officer, Hong Kong and Shanghai Banking Corporation | Member |
| Dr. M. T. Raju | Professor and In-charge, Indian Institute of Capital Markets | Member |
| Smt. Shikha Sharma | Managing Director, ICICI Prudential Life Insurance Company | Member |
| Shri U. K. Sinha | Chairman and Managing Director, UTI Asset Management Co. Pvt. Ltd. | Member |

**Special Invitees**

| | |
|---|---|
| Shri Anand Sinha | Executive Director, Reserve Bank of India |
| Shri C.R. Muralidharan | Member, Insurance Regulatory and Development Authority |
| Shri G. C. Chaturvedi | Joint Secretary (Banking and Insurance), |
| Dr. K. P. Krishnan | Joint Secretary (Capital Markets), Government of India |
| Shri Amitabh Verma | Joint Secretary (Banking Operations), Government of India |
| Smt. Usha Narayanan | Executive Director, Securities and Exchange Board of India |
| Shri Arun Goyal | Director, Financial Intelligence Unit, Government of India |

## 3. Institutions & Market Structure

| | | |
|---|---|---|
| Shri C. M. Vasudev | Former Secretary, Department of Economic Affairs<br>Ministry of Finance<br>Government of India | Chairman |
| Shri C. B. Bhave | Chairman and Managing Director, National Securities Depository Ltd. (upto Febuary 15, 2008) | Member |
| Dr. K. C. Chakraborty | Chairman and Managing Director, Punjab National Bank | Member |
| Dr. R. Chandrasekhar | Dean, Academic Affairs, Institute for Financial Management and Research | Member |
| Dr. Ashok Ganguly | Chairman, Firstsource Solutions Ltd. | Member |
| Dr. Omkar Goswami | Chairman, CERG Advisory Pvt. Ltd. | Member |
| Shri Y. H. Malegam | Managing Partner,<br>S. B. Billimoria & Co.<br>Chartered Accountants | Member |
| Dr. Nachiket Mor | President, ICICI Foundation for Inclusive Growth | Member |
| Shri T.V.Mohandas Pai | Member of the Board, Infosys Ltd. | Member |
| Shri Gagan Rai | Chairman and Managing Director, National Securities Depository Ltd. (from Febuary 25, 2008) | Member |
| Dr. Janmejaya Sinha | Managing Director, Boston Consulting Group | Member |

**Special Invitees**

| | |
|---|---|
| Dr. R. B. Barman | Executive Director, Reserve Bank of India |
| Shri Anand Sinha | Executive Director, Reserve Bank of India |
| Shri C.R. Muralidharan | Member, Insurance Regulatory and Development Authority |
| Shri Jitesh Khosla | Joint Secretary (Corporate Affairs), Government of India |
| Dr. K. P. Krishnan | Joint Secretary (Capital Markets), Government of India |
| Shri Sandeep Parekh | Adviser (Legal), Securities and Exchange Board of India |

**4. Transparency Standards**

| | | |
|---|---|---|
| Shri Nitin Desai | Under-Secretary-General, United Nations | Chairman |
| Dr. Jaimini Bhagwati | Additional Secretary, Ministry of External Affairs, Government of India | Member |
| Dr. Shubhashis Gangopadhyay | Director, India Development Foundation | Member |
| Dr. Rajiv Kumar | Director and Chief Executive, Indian Council for Research on International Economic Relations | Member |
| Dr. Rajas Parchure | Faculty, Gokhale Institute of Politics and Economics, Pune | Member |
| Dr. Indira Rajaraman | Reserve Bank Chair Professor, National Institute of Public Finance and Policy | Member |
| Shri Mahesh Vyas | Managing Director & CEO, Centre for Monitoring Indian Economy | Member |

**Special Invitees**

| | |
|---|---|
| Dr. R. B. Barman | Executive Director, Reserve Bank of India |
| Shri Jitesh Khosla | Joint Secretary (Corporate Affairs), Ministry of Corporate Affairs Government of India |
| Dr. M. C. Singhi | Economic Advisor, Department of Economic Affairs, Ministry of Finance Government of India |
| Shri P. K. Nagpal | Executive Director, Securities and Exchange Board of India |

## Annex IV

### Technical Group on Financial Stability Assessment and Stress Testing

| No. | Name | Designation/Organisation | |
|---|---|---|---|
| 1. | Shri C.S. Murthy | Chief General Manager-in-charge, RBI | Member |
| 2. | Shri P.Krishnamurthy | Chief General Manager-in-charge, RBI | Member |
| 3. | Shri Prashant Saran | Chief General Manager-in-charge, RBI | Member |
| 4. | Shri N.S. Vishwanathan | Chief General Manager, RBI | Member |
| 5. | Shri Chandan Sinha | Chief General Manager, RBI | Member |
| 6. | Dr. A.S Ramasastri | Adviser, RBI | Member |
| 7. | Shri Sudarshan Sen | Chief General Manager, RBI | Member |
| 8. | Dr. Charan Singh | Director, RBI | Member |
| 9. | Shri S. Ramann | Chief General Manager, SEBI | Member |
| 10. | Shri K. Kanagasabapathy | Secretary to CFSA | Convener |

### Technical Group for Aspects of Stability and Performance of Insurance Sector

| No. | Name | Designation |
|---|---|---|
| 1. | Shri S.V. Mony | Secretary General, Life Insurance Council |
| 2. | Shri S. P. Subhedar | Senior Advisor, Prudential Corporation, Asia |
| 3. | Shri N. S. Kannan | Executive Director, ICICI Prudential Life Insurance Company Ltd |
| 4. | Prof R. Vaidyanathan | Professor (Finance), IIM Bangalore |
| 5. | Dr. K. Sriram | Consulting Actuary, Genpact |

**List of Officials also Associated with the Technical Group's/Panel's Deliberations on Financial Stability Assessment and Stress Testing**

| No. | Name | Designation/Organisation |
|---|---|---|
| 1. | Shri T.V.Mohandas Pai | Member of the Board and Director-Human Resources, Infosys |
| 2. | Shri Anand Sinha | Executive Director, RBI |
| 3. | Shri S.K. Mitra | Executive Director, NABARD |
| 4. | Dr. Nachiket Mor | President, ICICI Foundation for Inclusive Growth |
| 5. | Shri H. N. Sinor | Former Chairman, IBA |
| 6. | Shri Akhilesh Tuteja | Executive Director, KPMG |
| 7. | Shri G. Padmanabhan | Chief General Manager, RBI |
| 8. | Shri A. P. Hota | Chief General Manager, RBI |
| 9. | Shri A. K. Khound | Chief General Manager-in-charge, RBI |
| 10. | Shri M. P. Kothari | Chief General Manager, DICGC |
| 11. | Shri K.D. Zacharias | Legal Adviser-in-Charge, RBI |
| 12. | Dr. Janak Raj | Adviser, RBI |
| 13. | Dr. A. M. Pedgaonkar | Chief General Manager, RBI |
| 14. | Shri R. Ravi Chandran | Chief General Manager, SEBI |
| 15. | Shri B. B. Mohanty | Chief General Manager, NABARD |
| 16. | Shri S. Ramann | Chief General Manager, SEBI |
| 17. | Shri R. Nagarajan | Chief General Manager, SBI |
| 18. | Ms. Ritu Anand | Principal Adviser & Chief Economist, IDFC |
| 19. | Shri R. Bhalla | General Manager, NHB |
| 20. | Shri P.R. Ravimohan | General Manager, RBI |
| 21. | Shri E. T. Rajendran | General Manager, RBI |
| 22. | Shri Somnath Chatterjee | Director, RBI |
| 23. | Shri S. Ganesh Kumar | General Manager, RBI |
| 24. | Shri A. S. Meena | General Manager, RBI |

| | | |
|---|---|---|
| 25. | Dr. Ashok Hegde | Vice President, MindTree Consulting Ltd |
| 26. | Smt. Asha P. Kannan | Director, RBI |
| 27. | Shri R. K. Jain | Director, RBI |
| 28. | Shri Anujit Mitra | Director, RBI |
| 29. | Shri Rajan Goyal | Director, RBI |
| 30. | Smt. R. Kausaliya | Director, RBI |
| 31. | Shri Neeraj Gambhir | Former General Manager, ICICI |
| 32. | Shri B. P. Tikekar | Senior Vice President, HDFC |
| 33. | Shri S. Ray | Senior Vice President, CCIL |
| 34. | Shri Ashok Narain | Deputy General Manager, RBI |
| 35. | Shri T. Rabi Shankar | Deputy General Manager, RBI |
| 36. | Shri K. Babuji | Deputy General Manager, RBI |
| 37. | Shri K.R. Krishna Kumar | Deputy General Manager, RBI |
| 38. | Shri Susobhan Sinha | Deputy General Manager, RBI |
| 39. | Shri Aloke Chatterjee | Deputy General Manager, RBI |
| 40. | Shri Sunil T. S. Nair | Deputy General Manager, RBI |
| 41. | Shri Shayama Chakraborty | Deputy Director, IRDA |
| 42. | Shri R. Chaudhuri | Deputy General Manager, ICICI Bank |
| 43. | Shri V. Konda | Deputy General Manager, ICICI Bank |
| 44. | Shri Rakesh Bansal | Deputy General Manager, ICICI Bank |
| 45. | Shri N. Muthuraman | Director, CRISIL |
| 46. | Shri Somasekhar Vemuri | Senior Manager, CRISIL |
| 47. | Shri G. Sankaranarayanan | Former Senior Vice President, Indian Banks Association |
| 48. | Shri Puneet Pancholy, | Assistant General Manager, RBI |
| 49. | Shri D. Sathish Kumar | Assistant General Manager, RBI |
| 50. | Shri Divyaman Srivastava | Assistant General Manager, RBI |
| 51. | Shri Y. Jayakumar | Assistant General Manager, RBI |
| 52. | Shri K. Vijay Kumar | Assistant General Manager, RBI |
| 53. | Shri Navin Nambiar | Assistant General Manager, RBI |
| 54. | Shri N. Suganandh | Assistant General Manager, RBI |
| 55. | Shri Ashok Kumar | Assistant General Manager, RBI |
| 56. | Shri Ashish Kumar Verma | Assistant General Manager, RBI |
| 57. | Shri Prabhat Gupta | Assistant General Manager, RBI |
| 58 | Shri Brij Raj | Assistant General Manager, RBI |

| | | |
|---|---|---|
| 59. | Shri D.P. Singh | Assistant Adviser, RBI |
| 60. | Shri Indranil Bhattacharya | Assistant Adviser, RBI |
| 61. | Dr. Pradip Bhuyan | Assistant Adviser, RBI |
| 62. | Shri Unnikrishnan N. K. | Assistant Adviser, RBI |
| 63. | Dr. Saibal Ghosh | Assistant Adviser, RBI |
| 64. | Smt. Anupam Prakash | Assistant Adviser, RBI |
| 65. | Shri Jai Chander | Assistant Adviser, RBI |
| 66. | Shri S. Madhusudhanan | Assistant General Manager, SEBI |
| 67. | Shri Vineet Gupta | Former General Manager, ICRA |
| 68. | Shri Ranjul Goswami | Director, Deutsche Bank |
| 69. | Shri Abhilash A. | Legal Officer, RBI |
| 70. | Shri M. Unnikrishnan | Legal Officer, RBI |
| 71. | Shri Piyush Gupta | Manager, RBI |
| 72. | Shri Aloke Kumar Ghosh | Research Officer, RBI |
| 73. | Ms. Sangita Misra | Research Officer, RBI |
| 74. | Ms. P.B. Rakhi | Research Officer, RBI |
| 75. | Shri Dipankar Mitra | Research Officer, RBI |
| 76. | Shri S.K. Chattopadhyay | Research Officer, RBI |
| 77. | Shri Samir Ranjan Behera | Research Officer, RBI |

## Technical Group on Financial Regulation and Supervision

| No. | Name | Designation/Organisation | |
|---|---|---|---|
| 1. | Shri G. Gopalakrishna* | Chief General Manager-in-charge, RBI | Member |
| 2. | Shri P. Krishnamurthy | Chief General Manager-in-charge, RBI | Member |
| 3. | Shri A. K. Khound | Chief General Manager-in-charge, RBI | Member |
| 4. | Shri G. Srinivasan | Chief General Manager-in-charge, RBI | Member |
| 5. | Shri G. Mahalingam | Chief General Manager, RBI | Member |
| 6. | Dr. K.V. Rajan | Chief General Manager, RBI | Member |
| 7. | Dr. Janak Raj | Adviser, RBI | Member |
| 8. | Shri Shekhar Bhatnagar | General Manager, RBI | Member |
| 9. | Shri K. Damodaran | General Manager, RBI | Member |
| 10. | Shri Ananta Barua | Legal Adviser, SEBI | Member |
| 11. | Shri P K Goel | Additional Director, Financial Intelligence Unit | Member |
| 12. | Shri K. Kanagasabapathy | Secretary to CFSA | Convenor |

* Now Executive Director, RBI.

## List of Members who were a part of the Technical Group for Assessment of IAIS Core Principles

| No. | Name | Designation |
|---|---|---|
| 1. | Shri C.N.S. Shastri | Adviser, IRDA |
| 2. | Shri N.M. Goverdhan | Former Chairman, LIC of India |
| 3. | Shri K.N. Bhandari | Secretary General, General Insurance Council |
| 4. | Shri Thomas Mathew | Managing Director, Life Insurance Corporation of India |
| 5. | Shri Deepak M. Satwalekar | Chief Executive Officer, HDFC Standard Life Insurance Company Ltd. |

### List of Officials also Associated with the Technical Group/Panel Deliberations on Financial Regulation and Supervision

| No. | Name | Designation/Organisation |
|---|---|---|
| 1. | Shri V. K. Sharma | Executive Director, RBI |
| 2. | Shri V. S. Das | Executive Director, RBI |
| 3. | Shri S. K. Mitra | Executive Director, NABARD |
| 4. | Shri A. V. Sardesai | Former Executive Director, RBI |
| 5. | Smt. Vani Sharma | Former Regional Director, RBI |
| 6. | Shri S.R. Kamath | Former General Manager, Securities Trading Corporation of India |
| 7. | Shri Prashant Saran | Chief General Manager-in-charge, RBI |
| 8 | Shri P. Krishnamurthy | Chief General Manager-in-charge, RBI |
| 9. | Shri Salim Gangadharan | Chief General Manager, RBI |
| 10. | Shri Chandan Sinha | Chief General Manager, RBI |
| 11. | Smt. Surekha Marandi | Chief General Manager, RBI |
| 12. | Shri Vinay Baijal | Chief General Manager, RBI |
| 13. | Shri P.K.Panda | Chief General Manager, RBI |
| 14. | Shri B. B. Mohanty | Chief General Manager, NABARD |
| 15. | Shri Rakesh Bhalla | General Manager, NHB |
| 16. | Shri P. R. Ravimohan | General Manager, RBI |
| 17. | Shri K. Bhattacharya | General Manager, RBI |
| 18. | Shri R. C. Sarangi | General Manager, RBI |
| 19. | Shri R. Subramanian | Deputy General Manager, RBI |
| 20. | Shri Navin Bhatia | Deputy General Manager, RBI |
| 21. | Smt. Molina Chaudhury | Deputy General Manager, RBI |
| 22. | Shri Himanshu Mohanty | Deputy General Manager, RBI |
| 23. | Shri Susobhan Sinha | Deputy General Manager, RBI |
| 24. | Shri Aditya Gaiha | Deputy General Manager, RBI |
| 25. | Smt. Anupam Sonal | Deputy General Manager, RBI |
| 26. | Shri P.K. Das | Deputy General Manager, RBI |
| 27. | Shri V. I. Ganesan | Deputy General Manager, NABARD |
| 28. | Shri Sunil T. S. Nair | Deputy General Manager, RBI |
| 29, | Ms. Mamta Suri | Deputy Director, IRDA |
| 30. | Shri Anup Kumar | Assistant General Manager, RBI |
| 31. | Shri S. Subbaiah | Assistant General Manager, RBI |
| 32. | Shri Puneet Pancholy | Assistant General Manager, RBI |
| 33. | Shri Prabhat Gupta | Assistant General Manager, RBI |

### Technical Group on Institutions and Market Structure

| No. | Name | Designation/Organisation | |
|---|---|---|---|
| 1. | Shri K.D. Zacharias | Legal Adviser-in-Charge, RBI | Member |
| 2. | Shri Chandan Sinha | Chief General Manager, RBI | Member |
| 3. | Shri A. P. Hota | Chief General Manager, RBI | Member |
| 4. | Dr. Janak Raj | Advisor, RBI | Member |
| 5. | Shri P.R. Ravimohan | General Manager, RBI | Member |
| 6. | Shri D. Rajagopala Rao | General Manager, RBI | Member |
| 7. | Shri Amarjeet Singh | Regional Manager, SEBI | Member |
| 8. | Shri Pawan Kumar | Director, Ministry of Corporate Affairs | Member |
| 9. | Ms. Mamta Suri | Deputy Director, IRDA | Member |
| 10. | Shri K. Kanagasabapathy | Secretary to CFSA | Convenor |

### List of Officials also Associated with the Technical Group/Panel Deliberations on Institutions and Market Structure

| No. | Name | Designation/Organisation |
|---|---|---|
| 1. | Shri G. Padmanabhan | Chief General Manager, RBI |
| 2. | Shri T. B. Satyanarayana | General Manager, RBI |
| 3. | Shri R. N. Kar | General Manager, RBI |
| 4. | Shri Arun Pasricha | General Manager, RBI |
| 5. | Smt. Sudha Damodar | General Manager, RBI |
| 6. | Dr. (Smt.) Mohua Roy | Director, RBI |
| 7. | Shri Jaikant Singh | Director – Ministry of Corporate Affairs |
| 8. | Shri O. N. Ravi | Senior Vice President, CCIL |
| 9. | Ms. Bhavna Doshi | Senior Adviser, KPMG |
| 10. | Shri Vijay Kapur | Director, AASB |
| 11. | Shri P. Rama Rao | Official Liquidator, Ministry of Corporate Affairs |
| 12. | Shri Himanshu Mohanty | Deputy General Manager, RBI |
| 13. | Ms. Jyoti Jindgar | Deputy General Manager, SEBI |
| 14 | Shri Sunil T. S. Nair | Deputy General Manager, RBI |
| 15. | Ms. Mamta Suri | Deputy Director, IRDA |
| 16. | Ms. Nilima Ramteke | Assistant General Manager, RBI |
| 17. | Shri Puneet Pancholy | Assistant General Manager, RBI |

| | | |
|---|---|---|
| 18. | Shri K. Vijay Kumar | Assistant General Manager, RBI |
| 19. | Shri D. Sathish Kumar | Assistant General Manager, RBI |
| 20. | Shri N. Gopinath | Assistant General Manager, RBI |
| 21. | Shri A. Abhilash | Legal Officer, RBI |
| 22. | Shri B. Bohra | Legal Officer, RBI |
| 23. | Ms. Vandana Jindal | Assistant General Manager, SEBI |
| 24. | Shri S. Dhamodaran | Senior General Manager, ICICI Bank |
| 25. | Shri L.M. Devare | Official Liquidator, Bank of Karad Ltd. (in liquidation), Mumbai |
| 26. | Shri V.S. Rao | Regional Director (West), Ministry of Corporate Affairs |

### Technical Group on Transparency Standards

| No. | Name | Designation/Organisation | |
|---|---|---|---|
| 1. | Dr. M.D. Patra | Adviser-in-Charge, RBI | Member |
| 2. | Dr. R.K. Pattnaik | Adviser, RBI | Member |
| 3. | Dr. K.S. Ramachandra Rao | Principal Adviser, RBI | Member |
| 4. | Shri P. Vijaya Bhaskar | Chief General Manager, RBI | Member |
| 5. | Shri S.V. Raghavan | Chief General Manager, RBI | Member |
| 6. | Shri R.N. Kar | General Manager, RBI | Member |
| 7. | Shri R.N. Dubey | Additional Economic Adviser, MoF | Member |
| 8. | Shri P.K. Bindlish | Chief General Manager, SEBI | Member |
| 9. | Shri R.S. Jagpal | Deputy Director, IRDA | Member |
| 10. | Shri K. Kanagasabapathy | Secretary to CFSA | Convenor |

### List of Officials also Associated with the Technical Group/Panel Discussions on Transparency Standards

| No. | Name | Designation/Organisation |
|---|---|---|
| 1. | Dr. B.K. Bhoi | Adviser, RBI |
| 2. | Shri B.M. Misra | Adviser, RBI |
| 3. | Shri M.R. Anand | Additional Economic Adviser, Government of India |
| 4. | Shri R.N. Kar | General Manager, RBI |
| 5. | Ms. Saraswathy Shyamaprasad | General Manager, RBI |
| 6. | Shri V.P. Arya | General Manager, RBI |
| 7. | Shri A.B. Balwatkar | General Manager, DICGC |
| 8. | Dr. (Smt.) Mohua Roy | Director, RBI |
| 9. | Smt. R. Kausaliya | Director, DICGC |
| 10. | Shri Aditya Gaiha | Deputy General Manager, RBI |
| 11. | Shri Rajiv Ranjan | Director, RBI |
| 12. | Smt. Rekha Misra | Director, RBI |
| 13. | Shri J.K. Khundrakpam | Director, RBI |
| 14. | Smt. Kumudini Hajra | Director, RBI |
| 15. | Shri M. Ramaiah | Assistant Adviser, RBI |
| 16. | Shri D. Sathish Kumar | Assistant General Manager, RBI |
| 17. | Shri N. Gopinath | Assistant General Manager, RBI |
| 18. | Shri S.Venkateswaran | Assistant General Manager, SEBI |
| 19. | Shri H.K. Behera | Research Officer, RBI |

## Annex V

### List of Agencies Involved in the Assessment Exercise

**Regulatory Authorities/Government**

1. Reserve Bank of India
2. Securities and Exchange Board of India
3. Insurance Regulatory and Development Authority
4. Government of India
5. State Governments

**Others**

6. Auditing and Assurance Standards Board
7. Clearing Corporation of India Limited
8. Credit Rating Information Services of India Limited
9. Deutsche Bank
10. Foreign Exchange Dealers' Association of India
11. ICICI Bank Limited
12. ICICI Prudential Life Insurance Company
13. ICRA Ltd.
14. Indian Banks' Association
15. Infrastructure Development Finance Company
16. Institute of Chartered Accountants of India
17. KPMG India
18. National Bank for Agriculture and Rural Development
19. National Housing Bank
20. State Bank of India

## Annex VI

### List of Peer Reviewers

| No. | Subject | Peer Reviewer |
|---|---|---|
| 1. | **Financial Stability and Stress Testing:** | V Sundararajan<br>Consultant and former Deputy Director<br>IMF<br><br>Andrew Sheng<br>Former Chairman<br>Hong Kong Securities and Futures Commission |
| | **Financial Regulation and Supervision:** | |
| 2. | Assessment of Basel Core Principles | Eric S. Rosengren<br>President and Chief Executive Officer<br>Federal Reserve Bank of Boston |
| 3. | IOSCO Principles for Securities Market Regulation | Ranjit Ajit Singh<br>Managing Director<br>Securities Commission, Malaysia<br><br>Shane Tregillis<br>Deputy Managing Director<br>Monetary Authority of Singapore |
| 4. | IAIS Principles for Insurance Regulation | Carl Hiralal<br>Inspector of Financial Institutions<br>Central Bank of Trinidad and Tobago<br><br>Michael Hafeman<br>Independent Consultant<br>Canada |
| | **Institutions & Market Structure :** | |
| 5. | Accounting Standards | Ian Mackintosh<br>Chairman<br>Accounting Standards Board, UK<br><br>Kamal Gupta<br>FCA, India |
| 6. | Auditing Standards | Ian Mackintosh<br>Chairman<br>Accounting Standards Board, UK |

| | | |
|---|---|---|
| | | N. P. Sarda<br>Partner<br>Deloitte, Haskins & Sells, India |
| 7. | Payments and Settlement Systems | Greg Johnston<br>Head of Banking<br>Reserve Bank of Australia |
| 8. | Corporate Governance | Sir Andrew Large<br>Former Deputy Governor<br>Bank of England |
| 9. | Bankruptcy Laws | Thomas Baxter Jr.<br>General Counsel and Executive Vice-President<br>Federal Reserve Bank of New York |
| | | T.R.Sridharan<br>Former Chairman<br>Canara Bank, India |
| | **Transparency Standards:** | |
| 10. | Transparency in Monetary Policy | Sir Andrew Large<br>Former Deputy Governor<br>Bank of England |
| 11. | Assessment of Fiscal Transparency | Vito Tanzi<br>Former Director<br>Fiscal Affairs Department, IMF |
| 12. | Data Dissemination Standards | Neil Patterson<br>Former Director<br>Statistics Department, IMF |

## Annex VII

### Secretariat to CFSA*

| Sr. No. | Name | Designation |
|---|---|---|
| 1. | Shri K. Kanagasabapathy | Consultant, Secretary |
| 2. | Dr.(Smt.) Mohua Roy | Director |
| 3. | Shri Susobhan Sinha | Deputy General Manager |
| 4. | Shri Sunil T. S. Nair | Deputy General Manager |
| 5. | Shri Saibal Ghosh | Assistant Adviser |
| 6. | Shri D.Sathish Kumar | Assistant General Manager |
| 7. | Shri Nishanth Gopinath | Assistant General Manager |
| 8. | Shri Prabhat Gupta | Assistant General Manager |
| 9. | Smt. P.K. Shahani | Manager |
| 10. | Shri A.B. Kulkarni | Assistant Manager |
| 11. | Shri R.J. Bhanse | Assistant Manager |
| 12. | Shri S.S. Jogale | PS to Consultant |
| 13. | Shri B. G. Koli | Stenographer |

* Functioned as part of the Monetary Policy Department, RBI.

**Chapter II**

# Macroeconomic Environment

## 2.1 Introduction

An assessment of the financial sector needs to recognise the linkages between macroeconomic performance and financial stability. It has been well established that a well-functioning financial system promotes economic growth. Financial development has two mutually reinforcing effects. From the demand side, it promotes efficiency of investments through better allocation of resources and from the supply side it increases savings and, hence, the scale of investments.

There is evidence that financially developed economies seem to allocate their resources more efficiently. Financial intermediation enhances economic growth by channelling savings into productive areas of investment, while allowing individuals to reduce the risks associated with their liquidity needs. The Indian financial sector in terms of institutions, markets and infrastructure has expanded and acquired greater depth and vibrancy particularly after the reforms initiated in the early 1990s. In different phases, financial sector development in India has broadly been supply-led, inasmuch as the central bank and the government took an active role in promoting and nurturing institutions and markets.

As macroeconomic developments and shocks have an impact on the financial sector, the role of macro-prudential or financial stability analysis has gained importance in recent years among central banks, regulatory authorities and international agencies. Various macroeconomic developments such as an increase in inflation due to a spurt in crude oil/commodity prices, sudden inflow/outflow of capital, sharp increases in fiscal deficit, or sudden and sharp increases in interest rates/asset prices may have an adverse effect on financial institutions' balance sheets and financial markets and thereby have implications for financial stability. Macro stress testing has, therefore, assumed significance in recent years.

The Indian financial sector has expanded and acquired greater depth after the reforms initiated in the early 1990s.

Keeping this in view, the CFSA, drawing mainly on the assessment made by the Panel on Financial Stability Assessment and Stress Testing, has

briefly reviewed global economic developments and, against that backdrop, assessed the Indian economic scenario with the objective of identifying potential and key macroeconomic vulnerabilities of the Indian economy at the present juncture that could have a bearing on the stability of the financial sector.

After a relatively long period of robust growth with moderate inflation and benign market conditions, the global economic environment recently entered a turbulent phase following significant volatility in the prices of oil, commodities and food, and the emergence of the sub-prime crisis in the US around mid-2007. The financial crisis has deepened further during the past six months and entered a new turbulent phase in September 2008 which has severely affected confidence in global financial institutions and markets. The dislocation in financial markets has been particularly severe and the situation remains in flux. Given that the dimensions of this turmoil and its impact both on the real economy and on the world of finance are still uncertain, this period represents a turnaround inasmuch as it has generated a wide range of discussions on both policy and operational matters akin to the aftermath of the depression of the 1930s. The overall assessment of global economic trends as also related issues in the Indian context had to undergo a shift from a benign and optimistic outlook to a relatively more cautious and guarded one. This was because of the many downside risks. Therefore, even while the CFSA was progressing with its work, unfolding events made the Advisory Panels, as also the CFSA, approach the whole assessment of the financial sector, including that of the macroeconomic environment impinging on the performance of the financial sector, with the utmost humility.

Non-performing housing loans, declining global equity prices and the rising cost of default protection on corporate bonds has forced some major national and international banks to face significant losses. Alongside, tightening of bank credit standards in major industrial economies has reinforced worries of an impending credit crunch. The impact has been compounded by persistent volatility in international oil prices. Coinciding with the rise in global commodity and food prices, global inflation was at elevated levels in the early part of 2008-09, though inflation has started showing a decline consequent to softening of commodity and food prices very recently due to the deceleration in global demand.

This report assesses the key strengths and weaknesses of the Indian economy that have a bearing on the stability of the financial sector.

The adjustment process in advanced economies is incomplete and the extent of de-leveraging and its spasmodic unfolding has implications for global capital flows, exchange rates and the adjustment of domestic

economies to these shocks. With the growing integration of the Indian economy with the global markets, the weight of global factors, along with domestic considerations, has also become important in dictating macroeconomic policies and outcomes. While there are several positives pointing to a sustainable higher growth rate in the medium term, some of the global and domestic developments show heightened downside risks to the short-term outlook of both the global and Indian economies.

The flagging confidence in the global financial system and markets has gained utmost priority and the G-7 in October 2008 agreed on a five-point plan of action:

- Take decisive action and use all available tools to systemically support important financial institutions and prevent their failure.
- Take all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding.
- Ensure that banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and business.
- Ensure that the respective national deposit insurance and guarantee programmes are robust and consistent so that our retail depositors will continue to have confidence in the safety of their deposits.
- Take action, where appropriate, to restart the secondary markets for mortgages and other securitised assets. Accurate valuation and transparent disclosure of assets and consistent implementation of high-quality accounting standards are necessary.

This plan of action has been strongly endorsed by the IMF's International Monetary and Financial Committee.

The G-20 in its November 2008 summit agreed on five common principles to guide financial market reform: (i) strengthening transparency and accountability; (ii) enhancing sound regulation; (iii) promoting integrity in financial markets; (iv) reinforcing international co-operation; and (v) reforming international financial institutions (IFIs). The leaders also approved a detailed Action Plan that sets forth a comprehensive work plan to implement these principles so as to ensure that the action plan is fully and vigorously implemented.

The turmoil in financial markets has compelled central banks to evolve co-ordinated policy action to mitigate the impact of the crisis.

The turmoil in financial markets, the freezing of the money markets and spreading market failures and contagion are compelling central banks to evolve co-ordinated policy action to mitigate the impact of the current crisis. In this turbulent environment, many of the mainstream ideas about central bank independence, single objective, Lender of Last Resort (LoLR), and

Global economic growth is expected to slow down.

separation of regulation and supervision are coming under renewed discussion. The CFSA is aware that there is considerable thinking going on internationally on the issue of financial regulatory architecture, and on the changes that are needed to make the global financial system more resilient. The CFSA has followed these trends and approached related issues with considerable nuance and with a sense of utmost humility in the institutional and country context.

## 2.2 Global Economy

After stronger than expected growth up to the third quarter of 2007, most of the advanced economies have recorded a sharp deceleration in their growth towards the end of 2008, driven mainly by the financial crisis, which spread beyond the US sub-prime mortgage market to other jurisdictions. The world economy has entered a major downturn in the face of the most dangerous financial shock in the advanced economies since the 1930s. As per IMF estimates, global growth decelerated to 3.4 per cent in 2008 from 5.2 per cent in 2007. Slowdown has been witnessed in both advanced as well as emerging market economies like Argentina, China, India, Malaysia and Thailand during 2008. Global growth is now projected by the IMF to drop further to 0.5 per cent in 2009, along with recession in North America and Europe. It is however expected to improve to 3.0 per cent by 2010 (Table 2.1).

The overall balance of risks to the short-term global growth outlook thus remains heavily tilted to the downside. Financial risks remain high, as rising losses in the context of a global slowdown could add to the strains on capital and exacerbate the squeeze on credit availability. The pattern of exchange rate adjustments has borne little relationship to the pattern of current account balances. Rising international oil prices had raised the projected current account surpluses of oil exporting countries, international oil prices though, have declined rapidly of late.

Financial risks remain high. Increasing losses could add to the strains on capital and exacerbate the squeeze on credit availability.

Headline inflation firmed up in major economies up to August 2008, reflecting the combined impact of elevated food and fuel prices, as well as strong demand conditions, especially in emerging markets. The rising inflation, which was a concern for a major part of the year, has however eased since September 2008, and is now a declining concern on account of marked decline in food and fuel prices as well as augmentation of downward risks to growth from the intensification of the global financial market crisis. Globally, inflation has softened in several countries in recent months. According to the IMF, the combination of stabilising commodity prices and

**Table 2.1: Output Growth, Inflation and Interest Rates in Select Economies**

(per cent)

| Region/ Country | Real GDP* | | | | Consumer price Inflation | | Short-term interest rate |
|---|---|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2007 | 2008 | Current |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| **World** | **5.2** | **3.4** | **0.5** | **3.0** | **-** | **-** | |
| **Advanced economies** | **2.7** | **1.0** | (-2.0) | **1.1** | **2.1** | **3.5** | |
| *Of which* | | | | | | | |
| United States | 2.0 | 1.2 | (-2.0) | 1.6 | 4.3 | 3.8 | 0.51 |
| Euro Area | 2.6 | 0.8 | (-2.1) | 0.2 | 3.2 | 3.1 | 1.85 |
| Japan | 2.4 | (-0.2) | (-3.2) | 0.6 | 0.7 | 1.4 | 0.60 |
| **Emerging economies** | **8.3** | **6.3** | 3.3 | **5.0** | **6.4** | **9.2** | |
| Developing Asia | 10.6 | 7.8 | 5.5 | 6.9 | 5.4 | 7.8 | |
| China | 13.0 | 9.0 | 6.0 | 8.0 | 7.1 | 5.9 | 1.28 |
| India** | 9.3 | 5.3 | 5.0 | 6.5 | 5.5 | 8.2 | 4.74 |
| South Korea | 5.0 | 2.6 | (-5.9) | - | 3.9 | 4.7 | 2.52 |
| Singapore | 7.7 | 1.2 | (-7.2) | - | 6.6 | 6.5 | 0.58 |
| Thailand | 4.8 | 3.0 | (-1.8) | - | 4.3 | 5.5 | 2.05 |
| Argentina | 8.7 | 6.0 | (-2.7) | - | 8.2 | 8.6 | 14.56 |
| Brazil | 5.7 | 5.3 | 1.6 | 3.5 | 4.6 | 5.7 | 12.66 |
| Mexico | 3.2 | 1.5 | (-1.8) | 2.1 | 3.7 | 5.1 | 7.24 |
| **Central and Eastern Europe** | **5.4** | **3.2** | **(-0.4)** | **2.5** | **-** | **-** | |
| Russia | 8.1 | 6.0 | 1.0 | 1.3 | 12.6 | 14.1 | 13.00 |
| Turkey | 4.6 | 1.5 | (-1.5) | - | 8.2 | 10.5 | 12.90 |

Updated from World Economic Outlook – January 28, 2009 and 'The Economist' – February 28, 2009

* : Average annual change, in per cent;

** : for India, wholesale prices;

**Note:** Interest rate per cent per annum.

**Source:** IMF World Economic Outlook and The Economist.

slowdown of the economy would help contain inflationary pressures in 2009, which is expected to fall to 0.25 per cent, before edging up to 0.75 per cent in 2010.

Global financial markets witnessed heightened uncertain conditions during the first half of 2008. The financial market witnessed a cautious return of investor risk tolerance in the credit markets between mid-March 2008 and end-May 2008. As a result, spreads narrowed in credit markets and investor interest revived temporarily in equity markets. In sharp contrast, inter-bank money markets failed to recover as liquidity demand remained elevated. Spreads between LIBOR rates and overnight index swap rates increased in all three major markets, *viz.,* the US, the UK and the Euro area. Central banks continued to work together as well as individually to improve liquidity

conditions in financial markets. Financial markets, however, came under stress again in June 2008 and early July 2008 as concerns mounted about the losses and longer-term profitability of two US mortgage companies, *viz.*, Fannie Mae and Freddie Mac. In mid-September 2008, failures of certain major firms in the US further deepened the crisis across world markets. The IMF has recently revised its estimate of loss due to the sub-prime crisis to US $ 1.3 trillion. Overall, the markets have been volatile since mid-2007. While some recovery takes place whenever there is some central bank action, the markets tend to turn volatile again due to fresh developments.

During the last quarter of 2008, short-term interest rates in advanced economies witnessed a mixed trend, moving broadly in tandem with policy rates and liquidity conditions. Improved liquidity conditions resulted in decline in short-term interest rates generally in major economies in January 2009.

## 2.3 The Indian Context

The impressive performance of the Indian economy is testimony to the benefits of the economic reforms undertaken since the early 1990s. Real GDP growth averaged 5.7 per cent from 1991-92 to 1996-97, 5.2 per cent during 1997-98 to 2002-03 and 8.8 per cent from 2003-04 to 2007-08, making it one of the world's fastest growing economies in the latter period. Since 2003-04, there has been a distinct strengthening of the growth momentum. Restructuring measures by domestic industry, overall reduction in domestic interest rates, both nominal and real, improved corporate profitability, a benign investment climate amidst strong global demand and commitment to rule-based fiscal policy have led to the shift to a higher trajectory of real GDP growth over the 5-year period ended 2007-08; growth in the past three years has averaged 9.2 per cent per annum, the highest average during any three-year period in the history of independent India.

Central bank actions lead to some recovery, but the markets turn volatile again on fresh bad news.

As the sustained growth was accompanied by a decline in population growth, the growth of real per capita income improved from 3.4 per cent during 1997-2002 to 6.1 per cent during 2002-2008. While there may be debate on the exact timing of the growth acceleration, the various alternative approaches do suggest a move to the higher growth trajectory from the 1980s onwards and further acceleration in recent years. The growth is clearly associated with the consistent trends of increasing domestic savings and investment over the decades (Chart 2.1 & Chart 2.2). Since 2003-04, there has also been significant bank credit growth.

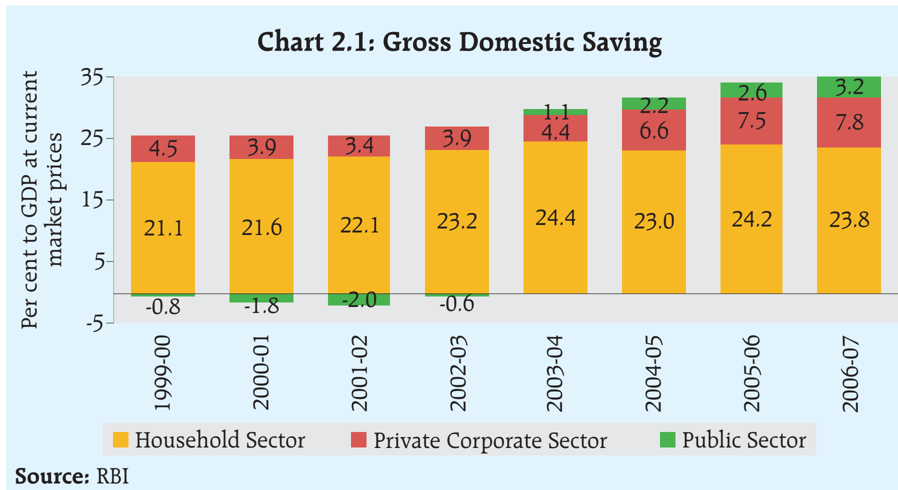



**Chart 2.1: Gross Domestic Saving**

**Source:** RBI

Besides a consistent upward trend in India's investment rate, there is evidence that capital has been employed productively. There are some signs of improvement in domestic productivity in the post-reforms period. A cross-country comparison indicates that Incremental Capital Output Ratio (ICOR) in India has been amongst the lowest in the world. This is especially true of the period from the 1980s onwards. Various reform measures aimed at increasing competitiveness appear to be having the desired impact on the productivity of the Indian economy. According to estimates by Bosworth and Collins, productivity gains accounted for almost 70 per cent of the growth in output per worker of the services sector during the period 1993-2004.

Unlike many of the East Asian economies, in India domestic demand has been the main driver of economic activity. The consumption GDP ratio – at nearly two-thirds – is one of the highest in Asia. The corporate sector has responded to increased global competition by improving productivity as manifest in an improvement in the ICOR from 6.6 in the 1970s to 3.6 during 2003-04 to 2006-07. This, in turn, has improved corporate profitability and, along with the improvement in public sector savings, enabled a pick-up in

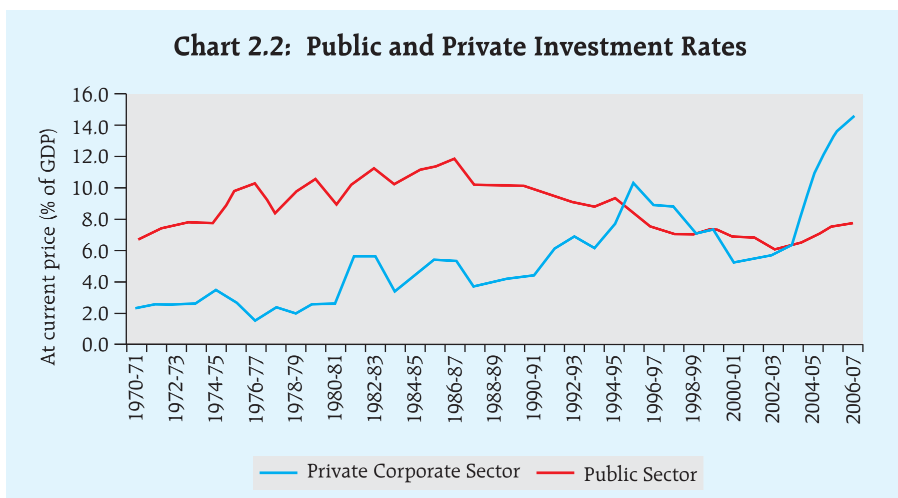



**Chart 2.2: Public and Private Investment Rates**

Productivity gains accounted for almost 70 per cent of the growth in output per worker of the services sector during 1993-2004.

After a brief period of significant increase in inflation during 2008-09, there has been a moderation in inflation rate of late.

investment rates, from 22.8 per cent of GDP in 2001-02 to 35.9 per cent in 2006-07.

Inflation rates were benign for most of the current decade. Thus, the annual average increase in the Wholesale Price Index between 2000-01 and 2007-08 was 5.1 per cent and the annual average increase in CPI between the same periods was 4.6 per cent. After a brief period of significant increase in inflation during 2008-09, as has also happened globally, of late there has been moderation in inflation rates due to cooling down of energy and commodity prices in particular. Inflation stood at 3.0 per cent as on February 21, 2009, considerably down from the high of 12.9 per cent in August 2008.

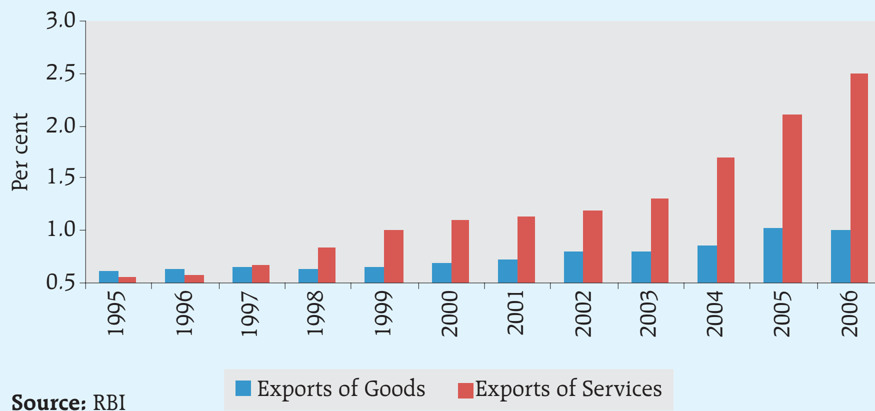
In response to increased perceptions of inflationary pressures, the Reserve Bank had gradually raised policy rates from 2004. The Cash Reserve Ratio was also raised during this period to 9.00 per cent. The repo rate was increased in stages from 4.75 per cent in October 2004 to 9 per cent in July 2008 before a gradual decline to 5.0 per cent in March 2009. The reverse repo rate was increased from 4.75 per cent in October 2004 to 6 per cent in November 2008. However, the reversal of capital flows which has led to liquidity concerns in the economy has induced the Reserve Bank to reduce in stages the Cash Reserve Ratio to 5.0 per cent.The repo and reverse repo rates have been reduced in stages to 5.0 per cent and 3.5 per cent, respectively. There has been a reduction in the Statutory Liquidity Ratio from 25 per cent to 24 per cent. It also tightened prudential norms, including increasing provisioning requirements and raising risk-weights in select sectors, with some relaxations in November-December 2008 as a contra-cyclical measure. Indicators on financial soundness, including stress tests of credit and interest rate risks, nevertheless suggest that banks' balance sheets remain healthy and robust. The liquidity ratio analysis of the banking system has however, shown a few concerns, that need to be addressed.

Indicators of financial soundness suggest that banks' balance sheets are robust.

Since 2003-04, there has been a significant jump in bank credit growth, which could be partly attributed to the step-up in real GDP growth, decline in interest rates, intensive policy initiatives to improve flow of credit to sectors like agriculture and, finally, strong demand for retail credit, particularly housing. The ratio of outstanding bank credit to GDP initially declined from 30.2 per cent at end-March 1991 to 27.3 per cent at end-March 1997; over the next decade, the ratio of bank credit to GDP more than doubled to reach about 60 per cent by end-March 2008.

Merchandise exports have been growing and becoming increasingly broad-based in terms of destinations and composition, reflecting India's

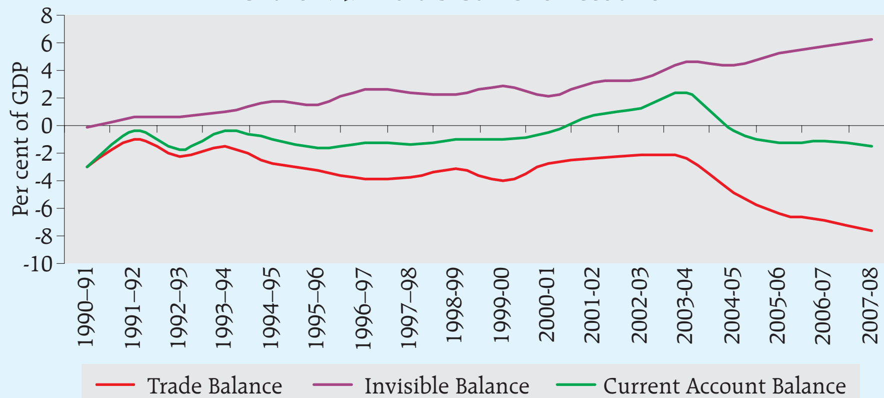
**Chart 2.3: India's Share in World Exports of Goods and Services**




**Source:** RBI

growing integration into the global economy (Chart 2.3). Based on Balance of Payments (BoP) data, merchandise exports to GDP increased from 5.8 per cent in 1990-91 to 9.9 per cent in 2000-01 and to 14.2 per cent in 2007-08. A striking feature of export growth has been the rapid growth in services exports. The growth in imports has also been rapid, with the imports to GDP rising from 8.8 per cent in 1990-91 to 12.6 per cent in 2000-01 and to 22.0 per cent in 2007-08. Despite the widening trade deficit, the current account deficit has remained modest, due largely to high levels of private transfers and increasing service sector exports (Chart 2.4). India is the leading remittance-receiving country in the world with relative stability of such inflows. Thus, while the merchandise trade deficit has increased from 2.7 per cent in 2000-01 to 7.8 per cent in 2007-08, the current account balance has been in the range of (-) 0.4 per cent and 2.3 per cent during this period. Strong capital inflows have been instrumental in financing the current account deficit. A positive investment climate and progressive liberalisation of the FDI policy regime, along with the rising pace of mergers and acquisitions across diverse sectors, contributed to a significant rise in both portfolio and FDI flows in recent years (Chart 2.5). The global financial turmoil has, however, led to a reversal in trend in respect of

**Chart 2.4: India's Current Account**



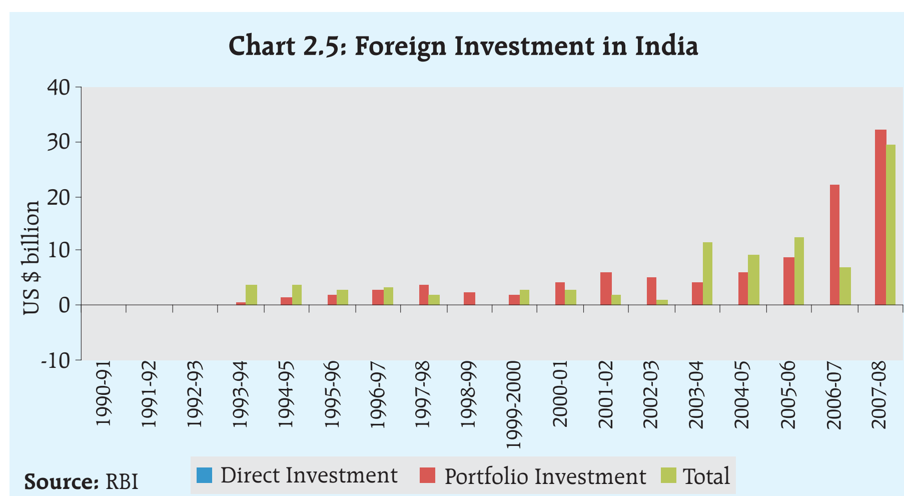

**Source:** RBI

both trade and capital flows in 2008-09 which has impacted the capital market and foreign exchange markets significantly. The foreign exchange reserves which reached a peak of USD 309.7 billion at end-March 2008 have declined and stood at USD 249.3 billion as on February 27, 2009.

The rupee, exhibiting two-way movements against the US dollar during 2002-03 to 2007-08, remained in the broad range of Rs.39.25 and Rs.46.96 per US dollar during this period. The rupee has witnessed highly volatile conditions since mid-September and early October 2008, driven by global market uncertainties. During 2008-09, till end January 2009, the rupee has depreciated and moved in the range of Rs.39.89-50.53 per US dollar (RBI Reference Rate). On an annual average basis, however, the real effective exchange rate of the Indian rupee based on trade-weight measures reflected an appreciation of 6.7 per cent in 2007-08. Net market purchases by the Reserve Bank amounted to US $ 78.2 billion during 2007-08 as against US $ 26.8 billion in 2006-07.

Financial markets in India in general have gained in depth, liquidity and resilience on account of various policy measures initiated over a period of five years. Interest rates in various segments of the financial market moved in tandem with the policy stance of the Reserve Bank. Initiatives have also been concurrently undertaken to strengthen the financial infrastructure necessary to support increased financial market activity. As per the BIS Triennial Central Bank Survey 2007, the foreign exchange market and derivative transaction volumes in India exhibited the fastest growth among the countries surveyed and currently compare well with some advanced countries.

Foreign exchange market volumes exhibited the fastest growth amongst the countries surveyed by the BIS.




**Source:** RBI

The fiscal position of the government since 2004-05 has been influenced by the rule-based fiscal correction process that is based on the Fiscal Responsibility and Budget Management (FRBM) Act implemented by the Government of India in July 2004. Similar legislations have been enacted by most of the States. The combined fiscal deficit of the Centre and States was budgeted to decline to 4.6 per cent of GDP in 2008-09 from 5.3 per cent as per the revised estimates (RE) for the previous year and 9.6 per cent in 2002-03. The continued increase in revenue receipts at a higher rate in relation to increases in expenditure led to improvement in all the deficit indicators during 2007-08 compared to the previous year. However as per the Interim Budget for 2009-10, the revised estimates in 2008-09 show a sharp increase in both revenue and fiscal deficit. Emerging fiscal pressures from the implementation of the Sixth Pay Commission recommendations, debt waivers and oil and fertilizer subsidies point, however, to the need for continued focus on fiscal balance. The Government and the Reserve Bank of India have also introduced a host of fiscal stimulus measures. However, given the current pressures on the economy in terms of global slowdown, oil price volatility, declared farm loan waivers coupled with various fiscal concessions that have been offered to keep the country on a high growth trajectory, it was not possible to contain fiscal deficit at the budgetary levels for the year 2008-09. The Government has in fact, deviated from its fiscal reform path and the FRBM targets have been relaxed to allow for higher spending as well as to absorb the impact of lower revenue growth expected in 2008-09 and 2009-10. The government has announced that it will return to FRBM targets, once the economy is restored to its recent trend growth path.

It was not possible for the Government to contain fiscal deficit at budgetary levels during 2008-09.

The strengthening of the market infrastructure and improvements in trading and settlement systems have made the Indian stock market one of the best in the world. The market has acquired greater depth over the years and is increasingly integrated with world markets. The insurance sector is also gradually moving away from the erstwhile state-owned regulated regime to one characterised by liberalisation and increased competition. The life insurance segment has been experiencing robust growth with increasing product diversification and customer orientation by both public and private players. The non-life segment has also been graduating towards risk-based pricing and health insurance products are being introduced.

Mr. Andrew Sheng, peer reviewer for Financial Stability and Stress Testing, by way of his general comment stated: "I want to commend the Indian authorities on the tremendous achievements in reforming the Indian financial system through their pragmatic and gradualist approach. The fact that India has not gone through any financial crisis as a result of financial deregulation is not only remarkable, but a testimony to the correctness of the judgment that reforms to global standards need to be adjusted to local conditions. The results have been impressive by any standards and the quality of the analysis and policies adopted are professional and objective."

Emerging fiscal pressures point to the need for continued focus on fiscal balance.

## 2.4 Potential Areas of Macroeconomic Vulnerability

Macroeconomic conditions in India have, in general, improved significantly in recent years with the economy witnessing robust growth and moderate inflation, except for temporary spikes in 2008-09 as has happened globally, coupled with a resilient banking system, improved depth and width of financial markets, and robust payment and settlement systems consequent to the implementation of RTGS. However, the Advisory Panel has identified several downside risks to macroeconomic prospects, which are summarised below.

### *2.4.1 Sustaining the Current Growth*

Given India's past record, when its economic growth has never grown at double-digit rates except in 1988-89 and the above 8 per cent growth has been achieved only in recent years, views have been expressed about the sustainability of India's current growth momentum. The IMF has projected India's growth would be 7.3 per cent in 2008 and 5.1 per cent in 2009. Drawing on the experience of other countries, several instances have been found in recent history when economies have grown at 8-9 per cent or higher annual rates for continuous periods. Therefore, 9 per cent growth in India during 2007-08 as well as the previous year cannot be viewed as an unusual phenomenon. In view of the positive features of the Indian economy, the Panel concluded that despite some marginal moderation in the immediate future due to uncertain global market conditions, India could return to an 8 per cent growth rate over the medium term as economic normalcy returns in the global economy.

The growth process was sustained in view of various growth enabling factors: (a) growth is led by demand – both of investment and consumption; (b) an upbeat investment climate for the medium and long term; (c) continued general upturn in capital goods production; and (d) record rise in sales and profits in the corporate sector. Though there will be a moderation in India's growth rate in the immediate future. As economic normalcy returns in the global economy, India has the potential to grow at 8-10 per cent in the medium term. Therefore, any growth rate of more than 8 per cent is assessed to be a sustainable rate for India.

8 per cent plus growth rate is sustainable over the medium term. But there may be a moderation in the short term.

Indian economic growth has been largely enabled by a sustained increase in the level of domestic savings. The efficiency of resource use has also been high with a long term ICOR of around four, which is comparable to the record of the best countries in the world. Hence, for 10 per cent plus

growth to be achieved, the continuation of growth in savings in each of the sectors – households, private corporate sector, public corporate sector and the government – would be essential, along with a prudent and sustainable absorption of external savings.

The recent acceleration in growth has been enabled by a surge in private sector investment and corporate growth. With regard to corporates, data available for the manufacturing sector reveals that the debt to equity ratio for public limited companies showed a general declining trend from 63 per cent in 2003-04 to about 50 per cent in 2006-07. In the case of private companies, though the ratio showed an increasing trend from about 15 per cent to 20 per cent between 2003-04 and 2005-06, the ratio was significantly lower than in the public sector. The profitability of Indian companies, measured by return on equity, was healthy and increased during the period under review. The current ratio for Indian companies was also above one, indicating comfortable liquidity.

The low debt to equity ratio points to higher internal accrual and buoyancy in the capital market. The question that arises is the sustainability of the low debt to equity ratio. There has been some moderation in sales and profits growth in 2007-08 that has begun to impact profitability, which could result in lower generation of internal funds going forward. Recently, there has also been a sharp correction in the valuations of listed firms, and thus there could be some reversal in the declining debt to equity ratio. Mr. Sundararajan, peer reviewer, has commented that sizeable reductions in debt to equity ratios of non-financial corporate sectors is one of the structural and conjectural factors which have contributed to financial stability, along with dominance of public sector banks and strategic management of capital account.

Going forward, there is a need to achieve an improved balance between financial development and financial stability. The improved performance of corporates has become possible with the improvement in fiscal performance reducing the public sector's draft on private savings, thereby releasing resources to be utilised by the private sector. For the growth momentum to be sustained, it is therefore necessary to continue the drive for fiscal prudence at both the central and state government levels.

The Panel has therefore noted that the public debt of the country is to be further brought down and fiscal discipline is to be ensured to sustain growth. At the same time, fiscal allocation to social and infrastructure sectors needs to be scaled up to sustain ongoing economic growth. The capital market is to be further developed and portfolio flows need to be prudently managed. Encouragement should be given for direct investment flows rather than portfolio flows. Above all, institutional reforms are to be strengthened in addition to reforms in the administrative machinery. Sustainability of corporate investment will crucially be conditioned by low and stable inflation enabling low and stable nominal and real interest rates.

There is a need to achieve an improved balance between financial development and financial stability.

The key to maintaining high growth with reasonable price stability lies in rapid capacity additions through investments, productivity improvements,

removal of infrastructure bottlenecks and amelioration of skill shortages. While monetary policy should continue to play a critical role in maintaining price stability, the sustainability of high growth with moderate inflation will depend critically on bolstering the twin pillars of growth, namely, fiscal prudence and high investment, and improving the effectiveness of government intervention in critical areas such as agriculture, education and health to achieve more inclusive growth.

### *2.4.2 Reversing Slowdown in Agriculture*

The performance of the agricultural sector is critical to sustain economic growth and maintain food security. Although the share of agriculture declined from over half of GDP in the 1950s to less than a fifth by 2006-07, there has not been a concomitant decline in the share of population dependent on agriculture; over half of the workforce is still dependent on this sector. The co-relation between agricultural growth and overall GDP growth has been observed to have strengthened over the reforms period.

In the present phase of growth momentum as witnessed in the service and industrial sectors, the agriculture sector has to grow faster than its long-term average growth rate of 2.5 per cent. If the agriculture sector remains in distress, growth can be neither inclusive nor sustainable. The most critical problems in the agricultural sector are low yields and the inability of farmers to exploit the advantages of the market. Clearly, the need of the hour is to modernise and diversify the agriculture sector by improving both the forward and backward linkages. These will include better credit delivery, investment in irrigation and rural infrastructure, improved cropping patterns and farming techniques, and development of the food processing industry and cold storage chains across the entire distribution system.

### *2.4.3 Fiscal Consolidation*

Among the other critical challenges is the way forward on fiscal consolidation, which is a necessary pre-requisite for sustained growth. High fiscal deficits would crowd out private investments. Depending on how they are financed, fiscal deficits can have an adverse impact on the economy through adverse movements in inflation, interest rates and the exchange rate. While the FRBM Act brought about a rule-based regime for consolidation both at the Central and State levels, the challenge lies in maintaining fiscal prudence so as to augment the levels of public sector savings. However, given the current pressures on the economy in terms of global slowdown, oil price increases (which have moderated considerably of late), and the consequent

impact on subsidies, the increase in revenue deficits, coupled with the declared farm loans waivers, and the implementation of Sixth Pay Commission recommendations, the CFSA recognised that it would be a challenging task to resume the fiscal correction after the current financial turmoil. Whereas there is a clear need and justification for fiscal expansion to counter the current global and domestic economic downturn, it is of the utmost importance that India return to its path of fiscal correction once the current crisis is over.

Some of the fiscal correction has been achieved by reduction in public investment. A desirable shift has taken place from public to private investment in sectors that essentially produce private goods and services, and there is a move towards public-private partnerships (PPP) in those which have aspects of both public good and private good. But it is necessary to recognise that public investment is essential in sectors providing public services. Continued fiscal correction through restructuring and reduction in subsidies, and continued attention to the mobilisation of tax revenues is necessary to enhance public sector savings that can then finance increases in levels of public investment. If this is not done, private corporate sector investment would be hampered, and the leads and lags in the availability of necessary public infrastructure would also lead to inflationary pressures, and lack of competitiveness.

*2.4.4 Meeting the Infrastructure Deficit*

Among the key concerns that businesses in India, as also foreign investors, face are those related to infrastructure, where there are significant gaps. In fact, the critical constraint to economic growth in India in recent years has been the infrastructure deficit. The Eleventh Plan document has estimated that to accelerate GDP growth at 9 per cent per annum during the Plan period, there is a need to accelerate the current level of investment in infrastructure at 5.0 per cent of GDP during 2006-07 to 9.0 per cent during the Plan period. Given the governance structure, policy uncertainty and lack of stricter entry and exit norms prevalent in the country, achieving this infrastructure target will be a challenge.

An investment requirement of roughly Rs.22,50,000 crore has been projected as financing requirements for physical infrastructure (comprising roads, power, telecom, railways, airports and ports). Out of this, an amount of roughly Rs.6,75,000 crore is to be funded by the private sector. With budgetary resources limited, the government has sought to foster a policy and procedural environment that actively encourages public-private partnerships (PPP). Additional efforts would bolster the PPP framework: strong and independent sector regulators would reduce regulatory uncertainties for investors, while developing domestic bond markets would facilitate infrastructure finance.

Sustained growth in private sector infrastructure investment can take place in only those sectors which are financially viable and exhibit adequate

It is required to enhance public sector savings that can finance increases in the level of public investment.

returns. The robust performance of the telecom sector has reflected this. A renewed focus on the levy of adequate user charges will therefore be necessary, along with policy measures that provide stability to the flow of infrastructure revenues.

There has been a paradigm shift in infrastructure funding from the government to the private sector mainly due to budgetary constraints in making funds available to meet the burgeoning financing requirements and the expected higher efficiency of the private sector. In addition, the emphasis on allocating budgetary resources to social sectors has also engendered this shift. As a result, the emphasis has shifted towards public-private partnerships (PPPs) and, increasingly, it is perceived that commercial entities such as banks could play an important role in this respect. Although the argument is not without its merits, there are significant challenges for the banking sector in funding the growing infrastructure need. It is estimated that debt finance for infrastructure would have to increase by more than 2.5 times a year on average during the next five years.

There are issues of asset-liability mismatch as the maturity of banks' assets has become longer term while their liabilities have become shorter. Banks will also reach exposure limits to large developers. Lending by Non-Banking Finance Companies (NBFCs) will be constrained, as they rely to a large extent on unsecured borrowings and to a certain extent on commercial banks for their funding – and the cost would be higher due to prudential requirements for bank lending to NBFCs. External Commercial Borrowing has to be managed prudently, in keeping with resulting macroeconomic vulnerabilities and desirable levels of capital flows. The investment by insurance companies in infrastructure companies is constrained by their investment guidelines.

All this points to the urgency in getting additional sources of debt financing for infrastructure investment – and increasing private participation/ financing – towards the goal of 9 per cent of GDP investment in infrastructure. This requires some shift from the bank-dominated financing system to a market-based one for financing infrastructure and housing projects, which would depend upon the development of an active corporate bond market. This requires the active development of domestic institutional investors. Reforms in the pension and insurance sectors will help in such institutional development so that pension funds and insurance companies can progressively acquire adequate size to become substantial investors in the

> There are significant challenges for the banking sector in funding infrastructure. Debt finance for infrastructure has to increase by more than 2.5 times.

domestic corporate market. Development of the municipal bond market, mortgage backed securities and the like would also be needed.

*2.4.5 Challenges in Reaping the Demographic Dividend*

It has been argued that as increasing numbers of people join the workforce in India, this will entail greater savings, as it did in other countries in East Asia that developed rapidly, where the greater bulge within the labour force created additional growth. While this is a favourable factor in sustaining productivity-led growth, there is need for rapid job creation, particularly in the hinterland states and the coastal areas. The employment growth rate (based on current daily status) accelerated from 1.25 per cent per annum during the period 1993-94 to 1999-2000 to 2.62 per cent during the period 1999-2000 to 2004-05. Because of the growing labour force, the unemployment rate (based on current daily status) rose from 7.31 per cent to 8.28 per cent during the same period. The overwhelming majority of the labour force continues to work in agriculture. The challenge going forward will be to create jobs on a scale needed to successfully absorb excess agricultural labour and the rapid increase in the labour force over the next decade. Investments in social sectors like education and health should receive particular attention.

*2.4.6 International Oil Prices*

As India is primarily an oil-importing country, oil prices constitute a critical element in the sustainability of the Indian growth process and maintenance of financial stability. An analysis by BIS in 2007 estimates that a supply-induced doubling of prices would raise the inflation rate in emerging Asia by as much as 1.4 percentage points above the baseline. International crude oil prices have risen sharply since June 2007, reflecting a tight supply-demand balance, geo-political tensions, the weakening of the US dollar against major currencies and increased interest from investors and financial market participants. Oil prices have of late moderated significantly due to expected deceleration in global economic activity.

The pass-through of international oil prices to domestic inflation is somewhat constrained because of the government's policy of price controls and cross-subsidies. But, this builds up pressures in the future. Apart from the inflationary pressure, any rise in international oil prices will have potential implications for the current account deficit and the exchange rate. If domestic prices are not raised commensurately, the rise in international crude prices will adversely affect the financial performance of domestic oil companies. This may necessitate further financial support to the oil companies from the Government, which would cause a strain on government finances.

The CFSA recognises, however, that adjustments in domestic oil prices to changes in international prices need to consider the volatility aspects, distinguishing between temporary spikes as happened recently and an enduring trend of rising prices. In the absence of any stabilisation funds, such adjustment mechanisms including special market operations by the Reserve

The development of a healthy corporate bond market is a must for meeting the financing needs of infrastructure.

Bank help tide over external shocks that impact the stability of local markets. With high exposure to oil imports that is combined with a widespread impact on the domestic economy, a more efficient use of oil products is warranted, such as thoroughly improved public transportation systems. New investments in upgrading public transport systems would not only contain the high dependency on oil, but also have positive externalities in terms of curbing climate change emissions.

*2.4.7 Food Prices*

Besides the oil price volatility, another major concern both domestically and globally has been the rise in food prices. However, the recent increase in food prices in India has been a fraction of that observed in many other countries. For example, the global prices of wheat and rice almost doubled between January and April 2008, while in India the increase has been less than one-tenth of that. Yet, the prices of food articles increased in India in 2006 and 2007, though moderated somewhat in 2008.

As regards prospects for the near future, public policies in regard to food, especially diversion to bio-fuel, cross-border trading, subsidies, and replenishment or use of buffer stocks would impact the evolution of prices globally. As regards India, on the supply side some abatement of global prices, the indication of better domestic supplies and addition to our buffer stocks, along with the series of measures already taken by the government are expected to yield results in the months to come.

*2.4.8 Managing the Impact of Capital Inflows*

Foreign investment flows into India, comprising foreign direct investment (FDI) and foreign portfolio investment (FPI), rose sharply during the 1990s reflecting the policies to attract non-debt creating flows. Net capital flows to India increased sharply to US $ 108.0 billion (or 9.2 per cent of GDP) during 2007-08, which was 2.4 times higher than the level in 2006-07. Both direct and portfolio investment flows by and large have maintained this pace in recent periods. Foreign direct investment flows into India were 50.5 per cent higher during 2007-08 on the back of a positive investment climate, improved growth prospects and initiatives aimed at liberalising the FDI policy and simplifying the procedures. Updated information on capital flows shows that net FDI flows and capital issues under American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) continued to support capital inflows. Gross FDI inflows increased to US $ 34.4 billion in 2007-08 from US $ 22.8 billion in the previous year. In 2008-09, however, there has been a

> With such high exposure to imports, more efficient use of oil products is urgently needed.

reversal in capital flows as net FII outflows were to the tune of US$ 11.9 bn. (till January 9, 2009). Based on the duration of the crisis, India may continue to face further outflows. There has also been a depreciation in the USD/Rupee exchange rate and a decline in stock market indices.

Judgements about excess volatility should depend not merely on the quantity of the flow, but on quality as well.

A success story in the Indian reforms process has been the gradual opening of the economy. On the one hand, trade liberalisation and tariff reforms have provided Indian companies with increased access to the best inputs available globally at almost world prices. On the other hand, the gradual opening has enabled Indian companies to adjust adequately to be able to compete both in world markets and with imports in the domestic economy. The performance of the corporate sector in both output growth and profit growth in recent years is testimony to this. It is therefore necessary to continue with the tariff reforms until India reaches world levels, beyond the current stated aim of reaching the levels of the Association of South East Asian Nations (ASEAN).

While the capital inflows eased the external financial constraint, they posed dilemmas for the conduct of monetary policy. Under the circumstances, the objectives of containing exchange rate volatility and the maintenance of orderly conditions in the foreign exchange market become difficult to achieve. More particularly, if capital inflows outstrip the demand for foreign exchange, the appreciation of the domestic currency often necessitates interventions by the central bank to drain off the excess supply of foreign currency. In doing so, the accretion to official reserves implies an immediate expansion in primary money supply with attendant consequences for maintaining price stability. In this context, judgements have to be made whether capital flows are of an enduring nature or temporary, which are difficult to make *ex-ante*. The judgement about excess volatility will depend not merely on the quantity of the flow, but to some extent on the quality in terms of components of the capital flow. Although the immediate focus could be on managing capital inflows, far in excess of the financing needs of the current account, and some volatility in regard to the excess, it would be prudent not to exclude the possibility of some change in course due to any abrupt changes in sentiments or global liquidity conditions as happened in mid-September 2008. Strategic management of the capital account would warrant preparedness for all situations. The significant changes experienced in capital flows in 2007-08 and in 2008-09 illustrate the volatile nature of such flows and the need for judicious capital account management consistent with the extant stance on monetary policy.

India's approach to the capital account has consistently made a distinction between debt and equity.

India's approach to the capital account has consistently made a distinction between debt and equity, with greater preference for liberalisation of equity markets *vis-à-vis* debt markets. Equity markets provide risk capital, which can be beneficial for growth. On the other hand, opening the domestic debt markets to foreign investors in the face of inflation and interest differentials, as is the case in India at present, can lead to large movements of arbitrage capital. In view of higher domestic nominal interest rates, open debt

markets can attract a large amount of capital flows and further add to the existing volume of capital flows, which are in any case well above the current account financing needs of the country. If the debt markets were open, such excess capital flows would have to be necessarily sterilised by the Reserve Bank in order to maintain domestic macroeconomic and financial stability. This would further add to the sterilisation costs already being borne by the country's financial sector and the Government. Thus, debt flows into India are subject to ceilings; such ceilings would be appropriate until wedges on account of higher inflation and interest rates narrow significantly over time. When reversal of sentiment takes place, as has happened in 2008, such flows also reverse rapidly; thus caution in operating foreign debt flows needs to be exercised.

Mr. V. Sundararajan, the peer reviewer for Financial Stability and Stress Testing, has commented that greater emphasis could and should be placed on the role further capital account liberalisation (CAL) can play in strengthening domestic financial markets. He has added that the sequencing and prioritisation of capital account policies and the associated prudential measures can be driven by the priorities for the development of domestic financial markets and need not be phased in over time mainly on the grounds of caution. He has mentioned that assuming that the measures to liberalise external capital flows and the associated prudential safeguards are implemented in tandem, a well-sequenced move towards fuller capital account can be a powerful financial sector development tool. Mr. Andrew Sheng has commented that the development of the capital market would play a major role when the rupee becomes more internationalised, which is a matter of time. It is therefore important to build this on a solid foundation while macroeconomic conditions remain favourable due to the young demographics and growing savings.

The CFSA recognises the role of capital account liberalisation in promoting growth among resource-constrained developing countries which need external capital to sustain an excess of investment over domestic saving. Financial openness fosters market efficiency by enabling residents to base investment and consumption decisions on world interest rates and prices. CAL also offers the opportunity of using the world market to diversify the portfolios of savers and investors. While the CFSA concurs with the broad thrust, there now appears to be a broad consensus that CAL is desirable, but should be gradual, well-sequenced and undertaken in conjunction with several other measures at the micro and macro level. Several policy areas have

been identified as being critical to the future health of global monetary and financial systems. There is certainly an implicit recognition that the net benefits from liberalisation of capital account in respect of any developing country would be enhanced if complementary policies are followed. While the Panel supported a general policy stance that encourages the liberalisation of CAL, this should be done strategically to help the evolution of the Indian financial markets in alignment with concomitant improvements in macro-economic management. Among the more important of these are: fiscal consolidation, sustained reduction in inflation to international levels, strengthening the banking system, diversifying financial intermediation through both banks and non-banks, and strengthening the regulation of financial markets.

## 2.5 Linkages between Macroeconomic Performance and Financial Stability

The macroeconomic shocks through vulnerability factors as listed above can be real or financial in nature. Shocks to the system influence financial institutions' balance sheets through the conventional channels of credit and market risk. They also affect the balance sheets of institutions through financial markets and asset prices. Both effects may amplify the first-round balance sheet impact, in particular liquidity and network effects. Taken together, all these channels can then translate into a final impact on balance sheets, causing risks to financial stability.

The resilience of the financial system can be tested by subjecting the system to stress scenarios. Stress tests at the level of individual institutions have been widely applied by internationally active banks since the early 1990s. In addition to applying stress tests to the portfolios of individual institutions at the micro level, stress testing is also assuming an increasingly important role in macro-prudential analysis. The main objective of an aggregate stress test is to help public authorities identify those structural vulnerabilities and overall risk exposures in a financial system that could lead to systemic problems.

In the above context, Mr. V. Sundararajan has commented that from a stability assessment perspective, the analysis of macroeconomic and external environment and sectoral developments should be systematically and explicitly linked to an assessment of the likelihood of shocks from the economy that are likely to impact the financial system. Ideally, stress scenarios need to be linked to a macroeconomic framework. Sometimes, macro-econometric or simulation models can be used to formulate forward-looking and internally consistent sets of values for key variables that define a stress scenario.

While the Advisory Panel was broadly in agreement with the above approach and recognises the importance of stress tests that reflect system resilience to one-time shocks, an important issue in stress testing is determining the yardsticks when setting the ranges of shock variables. In

Capital account liberalisation should be done strategically to help the evolution of the Indian financial markets in alignment with concomitant improvements in macroeconomic management.

India, stress-testing scenarios tend to be hypothetical due to the lack of past data on benchmarks. To get a more realistic view, there is a need to construct scenarios which are combinations of shock variables; however, the correlations among such variables need to be considered when constructing the scenarios. Hence, as in many other countries, macro stress testing in India is constrained by data availability and lack of a comprehensive macroeconomic model. In view of its importance for monetary and financial stability, there is a need to put in place a macroeconomic stress testing framework for assessment and surveillance on a regular basis.

While the Panel on Financial Stability Assessment and Stress Testing has addressed several areas of potential vulnerability by highlighting downside risks to stability at the current juncture, due to logistical and data constraint factors it has not attempted a quantitative stress test that builds upon the linkages between financial institutions' performance to macroeconomic shocks. In the next chapter the results of stress tests to certain shocks have been presented on the basis of single factor analysis. The Panel has however recommended that future assessment should incorporate more comprehensive stress tests that link institutional balance sheets to identified macroeconomic shocks. The CFSA concurs with this proposal.

## 2.6 Financial Development Index 2008 Rankings – Strengths and Weaknesses of the Indian Financial System

The World Economic Forum, a think-tank, undertook a research initiative aimed at providing business leaders and policymakers with a common framework to identify and discuss the key factors in the development of global financial systems and markets. This inaugural Financial Development Report provides an Index and ranking of 52 of the world's leading financial systems. As a prelude to the financial sector assessment that follows, the CFSA felt that it would be useful to summarise aspects of the strengths and weaknesses as revealed from India's rankings under each pillar.

The analysis, covering over 120 different data sets, has been grouped into seven major pillars which form the foundation of the index, *viz.*, institutional environment, business environment, financial stability, banks, non-banks, financial markets, and size, depth and access.

Systemic stress tests help identify structural vulnerabilities and overall risk exposures in the financial system.

### *2.6.1 Overall Ranking*

India is placed 31st in terms of its overall ranking. As per the Report, while India delivered solid results in terms of its financial markets

(particularly foreign exchange and derivatives) and its non-bank institutions, its banks appeared hamstrung by their small size, low efficiency and poor information disclosure. Despite this, the banking system has been considered very stable (ranked 5th) likely owing in part to sizeable capital buffers that help it weather credit cycles. As per the Report, the business environment shows significant room for development, characterised by an inhospitable tax regime and relatively poor contract enforcement. India has received low marks and rankings in relation to the liberalisation of its domestic financial sector and capital account. The quality of India's higher education institutions is apparent as seen in the high score for the quality of management schools (ranked 8th).

Among comparable countries, countries that were ranked higher than India include Malaysia (20), China (24) and Thailand (29), while countries that were ranked lower than India covered Pakistan (34), Indonesia (38) and the Philippines (48). Almost all Latin American countries, despite their financial openness, were ranked at the lower end of the spectrum ranging from 40 (Brazil) to 47 (Argentina).

India ranked above average in four out of seven pillars (Table 2.2). Below-average areas included institutional and business environment, and banks. The individual elements within the major pillars on which India is ranked relatively strong in the range of 1 to 10 are summarised in Table 2.3.

## 2.7 Concluding Observations

In spite of the current blips, the evidence indicates that the economy has moved firmly to a higher growth trajectory. Macroeconomic fundamentals continue to inspire confidence and the investment climate provides reasons for optimism. The change in growth trend also means that the economy needs to adequately prepare itself to meet incipient and ongoing challenges.

Going forward, it is essential to continue with focussed attention on achieving balance between financial development and financial stability. The key to maintaining high growth with reasonable price stability lies in rapid capacity additions through investments, productivity improvements, removal of infrastructure bottlenecks and amelioration of skill shortages. While

**Table 2.2: India's Ranking Under Financial Development Index**

| | Pillar | Ranking | |
|---|---|---|---|
| | | Above Average (11-31) | Below Average (32-52) |
| 1. | Institutional Environment | - | 43 |
| 2. | Business Environment | - | 45 |
| 3. | Financial Stability | 28 | - |
| 4. | Banks | - | 50 |
| 5. | Non-banks | 16 | - |
| 6. | Financial Markets | 22 | - |
| 7. | Size, depth and access | 28 | - |

**Source**: Financial Development Report, 2008, World Economic Forum.

**Table 2.3: India's Ranking under Individual Elements within the Major Pillars**

| Element | Rank | Element | Rank |
|---|---|---|---|
| Risk of systemic banking crisis | 5 | Share of World IPOs | 6 |
| Shareholder rights index | 1 | Share of total number of M&A deals | 9 |
| Quality of management schools | 8 | Real growth of direct insurance premiums | 1 |
| Quality of math and science education | 9 | Share of total securitisation deals | 9 |
| External debt to GDP | 3 | Public debt to GDP | 7 |
| Activity restriction for banks | 8 | Ease of access to credit | 10 |
| Capital restriction for banks | 4 | Ease of access to local equity market | 10 |
| Stability index | 1 | | |

**Source**: World Economic Forum - Financial Development Report-2008.
Detailed ranking of India under all the elements is provided in Annex I.

monetary policy will continue to play a critical role in maintaining price stability, the sustainability of high growth with moderate inflation will depend critically on bolstering the twin pillars of growth, namely, fiscal prudence and high investment; and improving the effectiveness of government intervention in critical areas such as agriculture, education and health in the quest for more inclusive growth. The oil and food price shocks could result in an increase in inflationary pressures and this, along with management of capital flows, could emerge as a major challenge for policymakers. Though the inflation has started showing a decline consequent to softening of energy, commodity and food prices very recently, the increased volatility in prices, along with manifestations in the financial sector will have the effect of causing a slowdown in global economic activity in major economies during 2008-09.

While financial sector reforms and development have considerably improved the system's resilience in India and the country has weathered both domestic and external shocks without any major adjustment thus far, the CFSA believes that reforms in the financial sector are a continuous process of responding to evolving circumstances and they should move in tandem and at times ahead of real sector responses. In a transition economy like India's, the leading role of supply in the development of the financial sector will continue to be relevant and government and regulators would thus continue to play a proactive role in that process. The findings and recommendations that follow should be viewed in that context.

# Annex I

**Financial Development Index: India's Ranking**
**(Figures in parentheses indicate rank amongst 52 countries)**

FACTORS, POLICIES, AND INSTITUTIONS

***1st pillar: Institutional environment*** ***Overall Rank – 43***

**Capital Account Liberalisation (Overall Rank – 46)**

| | | |
|---|---|---|
| 1.01 | Capital Account liberalisation | Below Average (46) |

**Corporate Governance (Overall Rank – 20)**

| | | |
|---|---|---|
| 1.02 | Extent of incentive-based compensation | Below Average (32) |
| 1.03 | Efficacy of corporate boards | Above Average (25) |
| 1.04 | Reliance on professional management | Above Average (21) |
| 1.05 | Willingness to delegate | Above Average (23) |
| 1.06 | Strength of auditing and accounting standards | Above Average (21) |
| 1.07 | Shareholder rights index | Strong area (1) |
| 1.08 | Ethical behaviour of firms | Below Average (34) |
| 1.09 | Protection of minority shareholder's interests | Above Average (21) |

**Legal and Regulatory Issues (Overall Rank – 28)**

| | | |
|---|---|---|
| 1.10 | Burden of government regulation | Below Average (32) |
| 1.11 | Centralisation of economic policy-making | Above Average (18) |
| 1.12 | Regulation of security exchanges | Above Average (23) |
| 1.13 | Property rights | Above Average (27) |
| 1.14 | Intellectual property protection | Above Average (29) |
| 1.15 | Diversion of public funds | Below Average (34) |
| 1.16 | Public trust of politicians | Below Average (38) |

**Contract Enforcement (Overall Rank – 49)**

| | | |
|---|---|---|
| 1.17 | Effectiveness of law-making bodies | Above Average (15) |
| 1.18 | Judicial independence | Above Average (18) |
| 1.19 | Irregular payments of judicial decisions | Above Average (30) |
| 1.20 | Number of procedures to enforce a contract | Below Average (48) |
| 1.21 | Time to enforce a contract | Below Average (51) |
| 1.22 | Cost of enforcing contracts | Below Average (46) |
| 1.23 | Strength of investor protection | Above Average (17) |
| 1.24 | Time to close a business | Below Average (51) |

**Domestic Financial Sector Liberalisation (Overall Rank – 38)**

| | | |
|---|---|---|
| 1.25 | Domestic financial sector liberalisation | Below Average (38) |

*2nd pillar: Business environment* *Overall Rank – 45*

**Human Capital (Overall Rank – 33)**

| | | |
|---|---|---|
| 2.01 | Quality of management schools | Strong area (8) |

| | | |
|---|---|---|
| 2.02 | Quality of math and science education | Strong area (9) |
| 2.03 | Extent of staff training | Above Average (23) |
| 2.04 | Local availability of research and training services | Above Average (24) |
| 2.05 | Brain drain and use of hiring foreign labour | Below Average (37) |
| 2.06 | Tertiary enrollment | Below Average (49) |
| **Taxes** | **(Overall Rank – 45)** | |
| 2.07 | Irregular payments in tax collection | Below Average (45) |
| 2.08 | Distortive effect on competition of taxes and subsidies | Below Average (39) |
| 2.09 | Corporate tax rate | Below Average (39) |
| **Infrastructure** | **(Overall Rank – 49)** | |
| 2.10 | Quality of overall infrastructure | Below Average (41) |
| 2.11 | Quality of telephone/fax infrastructure | Above Average (23) |
| 2.12 | Internet users | Below Average (44) |
| 2.13 | Broadband internet subscribers | Below Average (47) |
| 2.14 | Telephone lines | Below Average (50) |
| 2.15 | Mobile telephone subscribers | Below Average (52) |
| **Cost of Doing Business** | **(Overall Rank – 47)** | |
| 2.16 | Cost of starting a business | Below Average (50) |
| 2.17 | Cost of dealing with licenses | Below Average (44) |
| 2.18 | Cost of registering property | Below Average (45) |
| 2.19 | Cost to export | Above Average (22) |
| 2.20 | Cost to import | Below Average (46) |
| 2.21 | Cost of enforcing contracts | Below Average (46) |
| 2.22 | Cost of closing a business | Above Average (18) |
| ***3rd pillar: Financial Stability*** | | ***Overall Rank – 28*** |
| **Risk of a Currency Crisis** | **(Overall Rank – 13)** | |
| 3.01 | Change in real effective exchange rate | Above Average (15) |
| 3.02 | External vulnerability indicator | Above Average (26) |
| 3.03 | Current account balance to GDP | Below Average (40) |
| 3.04 | Dollarisation vulnerability indicator | Above Average (24) |
| 3.05A | External Debt to GDP (developing economies) | Strong area (3) |
| 3.05B | Net international investment position to GDP (advanced economies) | n/a |

**Risk of Systemic Banking Crisis** **(Overall Rank – 5)**

| | | |
|---|---|---|
| 3.06 | Activity restrictions for banks | Strong area (8) |
| 3.07 | Entry restrictions for banks | Below Average (33) |
| 3.08 | Capital restrictions for banks | Strong area (4) |
| 3.09 | Official supervisory power | Above Average (24) |
| 3.10 | Private monitoring of the banking industry | n/a |
| 3.11 | Frequency of banking crises | Above Average (12) |
| 3.12 | Stability Index | Strong area (1) |
| 3.13 | Cumulative real estate appreciation | n/a |

**Risk of Sovereign Debt Crisis** **(Overall Rank – 39)**

| | | |
|---|---|---|
| 3.14 | Local currency sovereign rating | Below Average (41) |
| 3.15 | Foreign currency sovereign rating | Below Average (38) |

FINANCIAL INTERMEDIATION

***4th pillar: Banks*** ***Overall Rank – 50***

**Size index** **(Overall Rank – 48)**

| | | |
|---|---|---|
| 4.01 | Size index | Below Average (48) |

**Efficiency index** **(Overall Rank – 41)**

| | | |
|---|---|---|
| 4.02 | Efficiency index | Below Average (36) |
| 4.03 | Public ownership of banks | Below Average (33) |

**Financial Information Disclosure** **(Overall Rank – 45)**

| | | |
|---|---|---|
| 4.04 | Public credit registry coverage | Above Average (21) |
| 4.05 | Private credit bureau coverage | Below Average (34) |
| 4.06 | Credit Information Index | Below Average (31) |

***5th pillar: Non-banks*** ***Overall Rank – 16***

**IPO Activity** **(Overall Rank – 12)**

| | | |
|---|---|---|
| 5.01 | IPO market share | Above Average (13) |
| 5.02 | IPO proceeds amount | Above Average (21) |
| 5.03 | Share of world IPOs | Strong area (6) |

**M&A Activity** **(Overall Rank – 16)**

| | | |
|---|---|---|
| 5.04 | M & A market share | Above Average (13) |
| 5.05 | M & A transaction value to GDP | Above Average (25) |
| 5.06 | Share of total number of M & A deals | Strong area (9) |

**Insurance** **(Overall Rank – 21)**

| | | |
|---|---|---|
| 5.07 | Insurance premiums, direct | Above Average (14) |
| 5.08 | Insurance density (43) | Below Average (43) |
| 5.09 | Real growth of direct insurance premiums | Strong area (1) |
| 5.10 | Insurance penetration | Above Average (23) |
| 5.11 | Relative value-added of insurance | Above Average (25) |

**Securitisation** **(Overall Rank – 13)**

| | | |
|---|---|---|
| 5.12 | Securitisation to GDP | Above Average (24) |
| 5.13 | Share of total number of securitisation deals | Strong area (9) |

***6th pillar: Financial Markets*** ***Overall Rank – 22***

**Foreign Exchange Markets** **(Overall Rank – 13)**

| | | |
|---|---|---|
| 6.01 | Spot foreign exchange turnover | Above Average (13) |
| 6.02 | Outright forward foreign exchange turnover | Above Average (11) |
| 6.03 | Foreign exchange swap turnover | Above Average (17) |

**Derivatives Market** **(Overall Rank – 14)**

| | | |
|---|---|---|
| 6.04 | Interest rate derivatives turnover: Forward rate agreements | n/a |
| 6.05 | Interest rate derivatives turnover: Swaps | Above Average (18) |
| 6.06 | Interest rate derivatives turnover: Options | n/a |
| 6.07 | Foreign exchange derivatives turnover: Currency Swaps | Above Average (11) |
| 6.08 | Foreign exchange derivatives turnover: Options | Strong area (9) |

**Equity Market Development** **(Overall Rank – 25)**

| | | |
|---|---|---|
| 6.09 | Equity market turnover | Above Average (17) |

**Bond Market** **(Overall Rank – 37)**

| | | |
|---|---|---|
| 6.10 | Private-sector bonds to GDP | Below Average (32) |
| 6.11 | Public-sector bonds to GDP | Above Average (19) |
| 6.12 | International bonds to GDP | Below Average (48) |

**CAPITAL AVAILABILITY AND ACCESS**

***7th pillar: Size, Depth, and Access*** ***Overall Rank – 28***

**Size and Depth** **(Overall Rank – 29)**

| | | |
|---|---|---|
| 7.01 | M2 to GDP | Above Average (19) |
| 7.02 | Private debt to GDP | Below Average (40) |
| 7.03 | Public debt to GDP | Strong area (7) |
| 7.04 | Bank deposits to GDP | Above Average (28) |
| 7.05 | Stock market capitalisation to GDP | Above Average (25) |
| 7.06 | Relative value-added of financial institutions to GDP | Above Average (14) |
| 7.07 | Private credit to GDP | Below Average (32) |
| 7.08 | Stock market value traded to GDP | Above Average (19) |

**Access** **(Overall Rank – 26)**

| | | |
|---|---|---|
| 7.09 | Financial market sophistication | Above Average (26) |
| 7.10 | Venture capital availability | Above Average (21) |
| 7.11 | Ease of access to credit | Strong area (10) |
| 7.12 | Ease of access to local equity market | Strong area (10) |
| 7.13 | Bank branches | Below Average (38) |
| 7.14 | Ease of access to loans | Above Average (25) |

# Chapter III

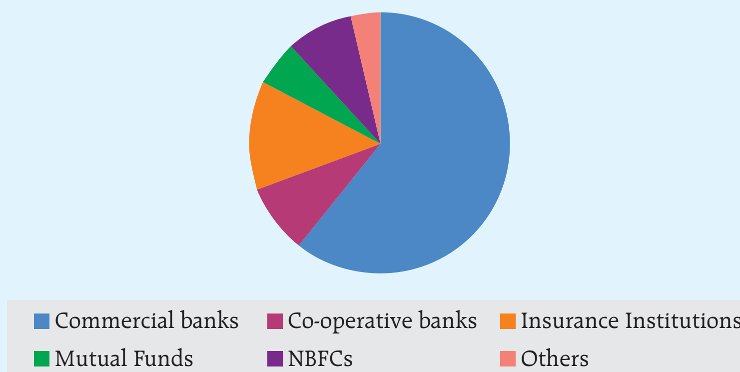
# Financial Institutions

## 3.1 Introduction

The Indian financial sector is still dominated by bank intermediation. Though the size of the capital market has expanded significantly with financial liberalisation in the early 1990s, bank intermediation remains the dominant feature. This chapter which addresses performance and stability aspects of financial institutions is divided into seven sections covering commercial banks, urban co-operative banks (UCBs), rural financial institutions, non-banking financial companies (NBFCs), housing finance companies (HFCs), Development Financial Institutions (DFIs) and the insurance sector. In addition to the various Panel Reports, the chapter draws on significantly from the Reserve Bank's Report on Currency and Finance 2006-08, which delineates the various existing and emerging challenges faced by the banking sector and suggests measures to address them as also benchmarks, wherever possible, the performance/practices of the Indian banking sector against international best practices.

Commercial banks are the dominant institutions in the Indian financial landscape accounting for around 60 per cent of its total assets (Chart 3.1).

**Chart 3.1: Indian Financial Institutions-Share of Assets - March 2008**




**Source:** RBI, SEBI, IRDA and Association of Mutual Funds of India (AMFI) documents

Though public sector banks (PSBs) account for around 70 per cent of commercial banking assets, competition in the banking sector has increased in recent years with the emergence of private players as also with greater private shareholding of PSBs. Listing of PSBs on stock exchanges and increased private shareholding have also added to competition. The new private banks which accounted for 2.6 per cent of the commercial banking sector in March 1997 have developed rapidly and accounted for nearly 17 per cent of the commercial banking assets by end-March 2008. Together with co-operative banks, the banking sector accounts for nearly 70 per cent of the total assets of Indian financial institutions.

The insurance sector, the second largest group of institutions, has also been opened up to private competition in recent years. The life insurance industry has reported compounded annual growth rate (CAGR) of 25.2 per cent during the period 2000-01 to 2007-08. A significant portion of the growth in the life insurance industry has been savings linked insurance products in the last few years. The non-life insurance segment has reported CAGR of 45.3 per cent during the period 2000-01 to 2007-08.

Non-banking financial companies (NBFCs) are witnessing robust growth mainly on the back of the high growth registered in its non-deposit taking segment. The assets under management of mutual funds has also increased significantly.

Over the past decade, financial institutions in India have benefited from a stable macroeconomic environment, with sustained growth especially from 2003 onwards when India recorded one of the highest GDP growth rates (CAGR of 8.8 per cent between 2003-08) in the world. This strong growth in the economy was accompanied generally by an acceptable level of inflation except for the temporary spike in inflation in 2008. Financial sector reform, which has been gradual and calibrated, has helped financial institutions to weather various global financial turmoils during the past ten years. This resilience is also currently evident, as the Indian financial sector has so far not been severely affected by the financial turbulence in advanced economies. There is, however, no room for complacency and the increasing global uncertainties need to be watched and guarded against appropriately. However, India has been affected by the crisis inasmuch as there has been drying up of capital flows with its resultant effect on the equity market and the rupee has depreciated against the US dollar. This, in turn, had an impact on overall liquidity in the system.

The Indian financial sector has so far not been severely affected by the financial turbulence in advanced economies. There is, however, no room for complacency and the increasing global uncertainties need to be watched and guarded against appropriately.

Financial institutions have transited since the mid-1990s from an environment of an administered regime to a system dominated by market-determined interest and exchange rates, and migration of the central bank from direct and quantitative to price-based instruments of monetary policy and operations. However, increased globalisation has resulted in further expansion and sophistication of the financial sector, which has posed new challenges to regulation and supervision, particularly of the banking system. In this context, the capabilities of the existing regulatory and supervisory structures also need to be assessed by benchmarking them against the best international practices.

The assessment of financial institutions has been undertaken by the Advisory Panels from two different perspectives. First, an analysis of the performance and resilience of the institutions has been carried out by the Advisory Panel on Financial Stability Assessment and Stress Testing. This has been supplemented with an assessment of the observance of Basel Core Principles (BCPs) in regulating and supervising these institutions by the Advisory Panel on Financial Regulation and Supervision (Box 3.1). The focus of the entire exercise has been on identifying issues and vulnerabilities which need to be addressed in the interest of bringing about continuous improvement in the sector and enabling it to adapt to emerging challenges.

**Box 3.1: Basel Core Principles for Banking Regulation and Supervision**

The Basel Committee on Banking Supervision had developed the core principles methodology in October 1999 which was subsequently revised in October 2006. It set international standards for benchmarking sound prudential regulation and supervision of banks. The 25 Core Principles are broadly classified into seven categories. Each BCP contains essential criteria for the system to be considered effective. The extent of fulfillment on essential criteria decides the observance status of each principle – compliant, largely compliant, materially non-compliant and non-compliant. The 25 BCPs are enumerated below:

**Category I: Objectives, autonomy and resources**

Principle 1: Objectives, independence, powers, transparency and co-operation.

This principle deals with (i) responsibilities and objectives of supervisor; (ii) independence, accountability and transparency of supervisor; (iii) legal framework; (iv) enforcement powers; (v) adequate legal protection for supervisors; and (vi) information sharing.

**Category II: Licensing powers**

Principle 2: Deals with permissible activities of banks.

Principle 3: Deals with licensing criteria and licensing process.

Principle 4: Requires supervisors to review and have the power to reject significant transfer of ownership of banks.

Principle 5: Requires supervisors to review major acquisitions and investments by banks.

**Category III: Prudential requirements and risk management**

Principle 6: Deals with minimum capital adequacy requirements.

Principle 7: Deals with identification, evaluation, monitoring and control of all risks.

The capabilities of the existing regulatory and supervisory structures need to be assessed by benchmarking them against the best international practices.

Principle 8: Deals with identification, evaluation and monitoring of credit risk.

Principle 9: Sets out requirements for evaluating asset quality and adequacy of loan loss provisions and reserves.

Principle 10: Sets forth rules for identifying and limiting concentrations of exposures to single borrowers or groups of related borrowers.

Principle 11: Sets out rules for lending to related parties.

Principle 12: Deals with identification, evaluation and monitoring country and transfer risk.

Principle 13: Deals with identification, evaluation and monitoring market risk.

Principle 14: Deals with identification, evaluation and monitoring liquidity risk.

Principle 15: Deals with identification, evaluation and monitoring operational risk.

Principle 16: Deals with identification, evaluation and monitoring interest rate risk in banking book.

Principle 17: Calls for banks to have adequate internal control systems.

Principle 18: Sets out rules for prevention of abuse of financial services.

**Category IV: Methods of ongoing supervision**

Principle 19: Deals with developing and maintaining thorough understanding of operations of individual banks and banking groups.

Principle 20: Defines overall framework for on-site and off-site supervision.

Principle 21: Sets out requirements of off-site supervision.

**Category V: Accounting and disclosure**

Principle 22: Accounting policies and practices to be followed for preparation of accounts.

**Category VI: Corrective and remedial measures**

Principle 23: Requires supervisor to have and promptly apply adequate remedial measures for banks when they do not meet prudential requirements.

**Category VII: Consolidated supervision**

Principle 24: Requires supervisor to apply global consolidated supervision over internationally active banks.

Principle 25: Requires supervisors to establish contact and exchange information with other supervisors/host country authorities.

**Source:** Basel Committee on Banking Supervision, October 2006.

The Advisory Panel on Financial Stability Assessment and Stress Testing conducted a comprehensive assessment of the financial institutions through a macroprudential analysis to assess the soundness and stability of the financial institutions. Subject to availability of data, this was supplemented by system-level single factor stress tests to assess the resilience of the financial institutions. Stress tests have been conducted for commercial banks,

scheduled urban co-operative banks and the insurance sector. Based on this assessment, the Advisory Panel suggested various measures to strengthen the institutions from a medium-term perspective. The Report of the Panel was peer reviewed by Mr. V. Sundararajan, former Deputy Director, IMF and Mr. Andrew Sheng, former Chairman of Hong Kong Securities and Futures Commission.

Ideally, identified sources of risks and vulnerabilities in the financial system should be systematically linked to assessments of supervision and regulation.

- Sundararajan

Mr. Sundararajan broadly concurred with the conclusions in the Report and found the scope and comprehensiveness of the assessments, and their technical quality to be impressive. His comments pertained mainly to the methodology and partly to the substance and structuring of the report. He observed that while the methodology for stress testing is broadly in line with that in the IMF's FSAP Handbook, the plausible shocks and vulnerabilities arising from domestic macroeconomic and external sectors should be systematically linked to the formulation of a set of stress scenarios. Moreover, the macroeconomic and institutional determinants of financial soundness indicators have not been clearly spelt out in some instances, and the likely evolution of Financial Soundness Indicators (FSIs) in response to various shocks needs further analysis. He was of the view that due to the growing use of purchased funds to support asset expansion, the analysis of second-round contagion effects – by stress testing the data on a matrix of bilateral inter-bank exposures – should be further developed. He mentioned that the identified sources of risks and vulnerabilities in the financial system should be systematically linked to assessments of supervision and regulation.

Mr. Andrew Sheng commended the Indian authorities on their achievements in reforming the Indian financial system and the fact that India has not gone through any financial crisis as a result of financial deregulation. He agreed with the analysis that there are challenges for the banking system to fund infrastructure needs, as is the need to develop the corporate bond market. He was of the view that the real issue is how to engineer a stable shift in the financial sector from a bank-dominated system to a capital market-oriented system, so that long-term funding is available to finance the long-term needs of the economy, such as housing and infrastructure. This would call for greater development of the pension and social security systems in preparation for an ageing population, as well as the creation of a secondary mortgage market for India. He observed that the development of the capital market would play a major role when the rupee becomes more internationalised. He supported the encouragement of consolidation through mergers and acquisitions of private banks and public sector banks (PSBs). He suggested that macroprudential regulation should start using more quantity-based instruments than hitherto to protect banks against asset bubbles. With regard to the performance of financial institutions, he was of the view that risk management is inextricably linked with governance and that as long as pay is constrained, PSBs may lose valuable staff with entrepreneurial skills to the higher-paying private financial institutions. On the issue of 51 per cent

Risk management is inextricably linked with governance.

- Andrew Sheng

The assessment of adherence to BCPs has been extended, as relevant and applicable to entities other than commercial banks.

state ownership constraint he opined that as a 'transition' to a more market-oriented PSB environment, as long as the state plus public pension funds owns more than 51 per cent, public pension funds could be counted as 'state'. On liquidity, he mentioned that as long as banks held more than 25 per cent government paper, they have more than enough liquidity since Indian banks are not yet at the 'originate to distribute' model, which requires almost total reliance on central bank's lender of last resort facilities to anchor individual bank liquidity. To avoid a repeat of the sub-prime type of problem, he recommended that bank supervisors should use more stress tests by individual institutions, supplemented by system-wide modelling of liquidity using different levels of margins and risk spreads. Also, the on-site examination process should be supplemented by a forensic 'follow the evolution of the product' approach.

While BCPs, in a strict sense, are applicable only to commercial banks, the Advisory Panel on Financial Regulation and Supervision had made an attempt to extend the principles, as relevant and applicable, to other categories of financial institutions, *viz.*, co-operative banks and NBFCs, including housing finance companies (HFCs). In the case of NBFCs, the Advisory Panel felt that the assessment was useful because NBFCs provide services similar to banks, are potential conduits in spreading systemic risk, and there is scope for regulatory arbitrage between NBFCs and banks. The assessment could also throw up developmental issues which, if implemented, could strengthen the regulation and supervision of NBFCs. As regards housing finance companies, the Panel felt the need to assess BCP compliance in HFCs in view of the contagion of HFCs to banks through borrowings. Also, risk-based capital requirements for HFCs are similar to the Basel-stipulated norms. Further, there is scope for regulatory arbitrage between HFCs and banks.

'There is an urgent need to improve co-ordination between regulatory agencies'.

- Eric Rosengren

Mr. Eric Rosengren, President, of the Federal Reserve Bank of Boston and the peer reviewer of the Report on Basel Core Principles prepared by the Advisory Panel on Financial Regulation and Supervision, noted that the assessment provides many useful insights into the Indian financial and banking systems. He was particularly happy to note that the report has recognised the critical need to attract and retain top-quality staff to serve in the supervisory and regulatory community. He felt that another key contribution of the report was that it pointed out the urgent need to improve co-operation among the regulatory agencies and suggested streamlining the

overall regulatory infrastructure in the long run. He also appreciated the report's recognition of the need to tailor the regulatory programme to fit the Indian financial system. He laid stress among other things on careful management of liquidity risk, issues relating to operational risk arising from usage of complex instruments and monitoring of conglomerates. The Panel incorporated the comments of Mr. Rosengren appropriately in its report.

The CFSA notes that though BCPs are not strictly applicable to financial institutions other than commercial banks, the Advisory Panel's efforts to extend the scope of BCP assessment to other sectors are commendable in the current context of the potential linkages of such institutions and their impact on the stability of the financial system. The Reserve Bank has already been extending such principles to non-bank entities, subject to certain thresholds and the nature of their operations. As regards the recommendations made by the Panel for convergence of status to BCP, the CFSA feels that the Reserve Bank should closely examine the rationale provided by the Panel and evaluate the necessity to move into tighter or fresh guidelines particularly taking into account their relevance from the perspective of systemic stability.

The CFSA also feels that the present global financial crisis has highlighted the limitations of the present Basel Core Principles inasmuch as the assessment does not specifically cover areas like SIVs/NBFCs or aspects like dynamic provisioning and countercyclical norms. Hence, the CFSA feels that the Basel Committee on Banking Supervision should revisit the Basel Core Principles to cover the new areas.

The regulation and supervision of the insurance sector has been benchmarked against IAIS core principles. Based on the gaps and vulnerabilities emanating from the assessments, the Panel on Financial Regulation and Supervision has made recommendations addressing development issues from the medium-term perspective. The portion of the Panel Report pertaining to the assessment of IAIS core principles was peer reviewed by Mr. Carl Hiralal, Inspector of Financial Institutions, Central Bank of Trinidad and Tobago and Mr. Michael Hafeman who is an independent consultant.

The CFSA believes that improvements in the strength and resilience of financial institutions must be viewed as a continuous process and the assessment and recommendations of the Panels should be viewed in this context.

## 3.2 Commercial Banks

### 3.2.1 Performance

#### 3.2.11 Business Size and Key Financial Soundness Indicators (FSIs)

Exhibiting healthy growth, the assets of commercial banks grew at a CAGR of 22.9 per cent between 2002 and 2008. Credit growth during this period (CAGR of 25.1 per cent) has far outstripped growth in investment by banks (CAGR of 10.1 per cent). With growing corporate dependence on

Basel Committee on Banking Supervision should revisit the Basel Core Principles to cover new areas.

internal accrual and external commercial borrowings to fund their operations, credit growth in the period after 2002 has been largely due to rapid expansion in the retail credit portfolio of banks. Deposits have been the primary funding source, accounting for 76 per cent of the asset base in 2008. The large increase in deposits and credit, as seen from the increase in their respective ratios to GDP between 1992 and 2007, has led to significant financial deepening (Table 3.1).

**Table 3.1: Scheduled Commercial Banks – Business Size as per cent of GDP (end-March)**

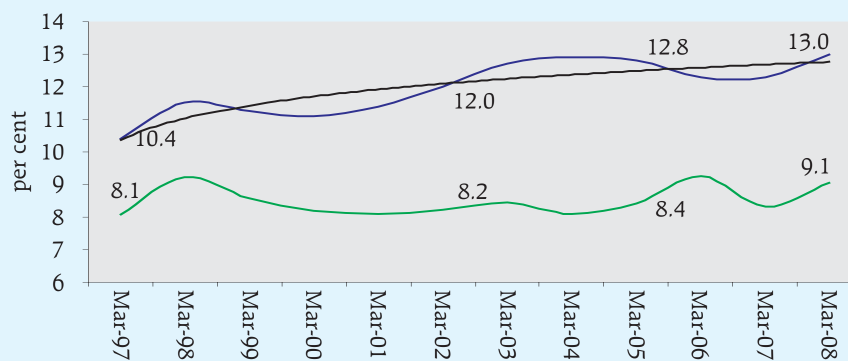
| | 1992 | 1997 | 2002 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| **Assets** | 52 | 49 | 67 | 75 | 78 | 84 | 92 |
| **Deposits** | 41 | 39 | 53 | 58 | 60 | 65 | 70 |
| **Borrowings** | 3 | 2 | 5 | 5 | 6 | 6 | 6 |
| **Advances** | 24 | 20 | 28 | 37 | 42 | 48 | 53 |
| **Investments** | 15 | 16 | 26 | 28 | 24 | 23 | 25 |

**Source**: Handbook of Statistics of the Indian Economy: 2006-07 and RBI (Supervisory data). GDP at market prices

With increased private shareholding in the banking sector, the assets of listed banks comprised 85 per cent of total commercial banking assets as on March 31, 2008. There has also been a significant improvement in bank performance, judged in terms of prudential and financial parameters, such as capital adequacy, asset quality and profitability ratios. Regulatory capital at the system level rose from 10.4 per cent in 1997 to 13.0 per cent by 2008, well above the regulatory minimum (Chart 3.2). The increase in Capital to Risk

Regulatory capital at the system level rose from 10.4 per cent in 1997 to 13.0 per cent by 2008

**Chart 3.2: CRAR of Scheduled Commercial Banks**




**Source:** RBI (Supervisory data).

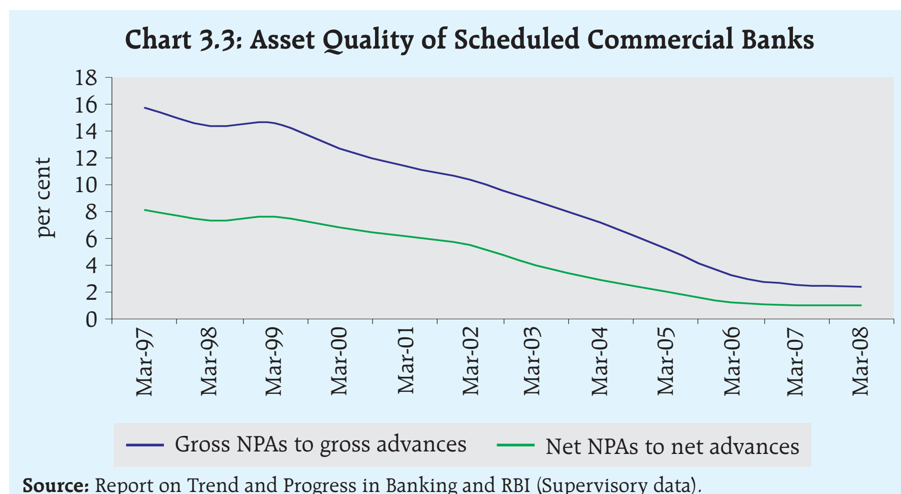
Weighted Assets Ratio (CRAR) from 12.3 per cent in March 2007 to 13 per cent in March 2008 is to be viewed against the implementation of Basel II norms which is expected to be completed by end-March 2009. The leverage ratio in the banking sector has reduced over time.

The non-performing asset ratios have shown secular decline.

There has been a consistent decline in non-performing asset (NPA) ratios over the years. The gross NPA ratio declined from 15.7 per cent to 2.4 per cent between 1997 and 2008; the net NPA ratio declined from 8.2 per cent to 1.1 per cent during this period. Improvement in the credit appraisal process, new legal initiatives aimed at faster NPA resolution and greater provisions and write-offs enabled by greater profitability contributed to this decline. However, in the recent period there has been a rapid increase in the retail loans portfolio, combined with some deterioration in NPAs of retail assets. Also, the current global financial turmoil can adversely affect corporate performance, which, in turn, could impact credit quality. Hence, there is a need, among other things, to improve credit risk assessment as well as collection of credit information, particularly with respect to retail assets (Chart 3.3).

In the context of the current global financial turmoil, credit risk assessment and collection of credit information need to be further improved.

**Chart 3.3: Asset Quality of Scheduled Commercial Banks**




**Source:** Report on Trend and Progress in Banking and RBI (Supervisory data).

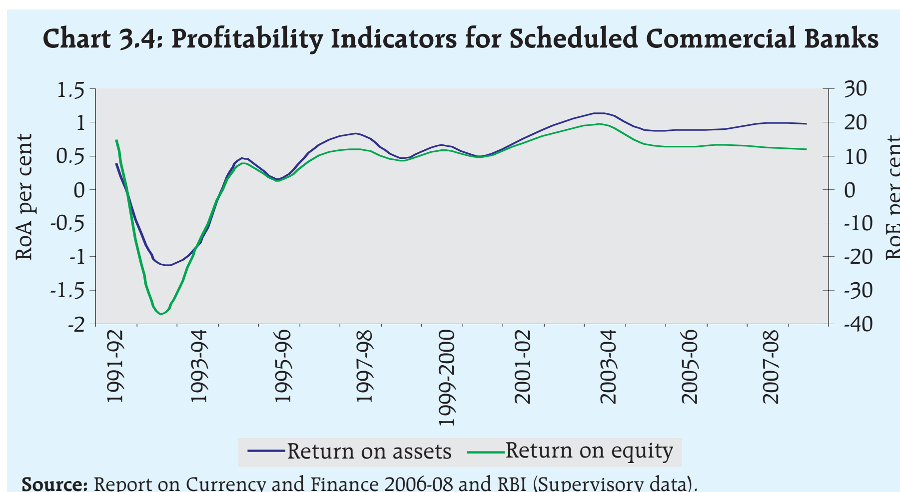
The Return on Assets (RoA), which was negative in 1992-93 and 1993-94 showed gradual improvement and hovered between 0.48 and 0.89 per cent between 1996-97 and 2001-02. The RoA further increased and remained around 1 per cent for most of the subsequent period until 2007-08 – a reflection of increased bank efficiency aided by a benign macroeconomic environment. Indian RoA was within the international benchmark, which ranged between 0.5 per cent and 2.5 per cent for 17 select countries in 2006. The Return on Equity (RoE) showed improvement over the years with a low of 8.6 in 1999-2000 to a high of 19.1 in 2003-04. RoE remained above 12 per cent in the subsequent years (Chart 3.4).

Commercial banks' RoA was within the international benchmark.

The cost-income ratio[2], a measure of efficiency, which was around 70 per cent in the 1990s, has come down significantly and hovered around a

[2] Cost-income ratio is the ratio of non-interest expenses to total income net of non-interest expenses.

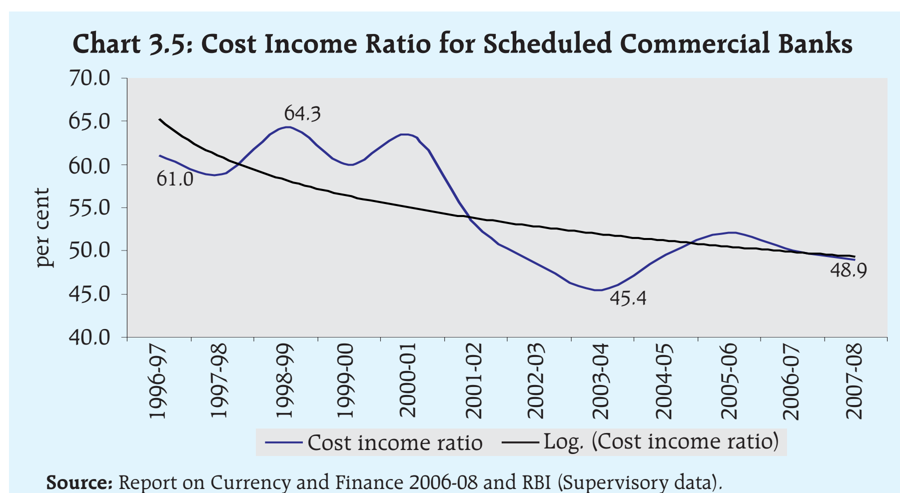
**Chart 3.4: Profitability Indicators for Scheduled Commercial Banks**




**Source:** Report on Currency and Finance 2006-08 and RBI (Supervisory data).

comfortable 50 per cent between 2001-02 and 2007-08 (Chart 3.5). This was achieved in spite of the large expenditure incurred by Indian banks for upgrading their technology. A study by the Reserve Bank, which assessed efficiency and productivity in the banking sector with the help of economic measures by adopting the data envelopment analysis (DEA)[3] methodology, showed that there has been significant improvement in cost, technical and allocative efficiency levels.

**Chart 3.5: Cost Income Ratio for Scheduled Commercial Banks**




**Source:** Report on Currency and Finance 2006-08 and RBI (Supervisory data).

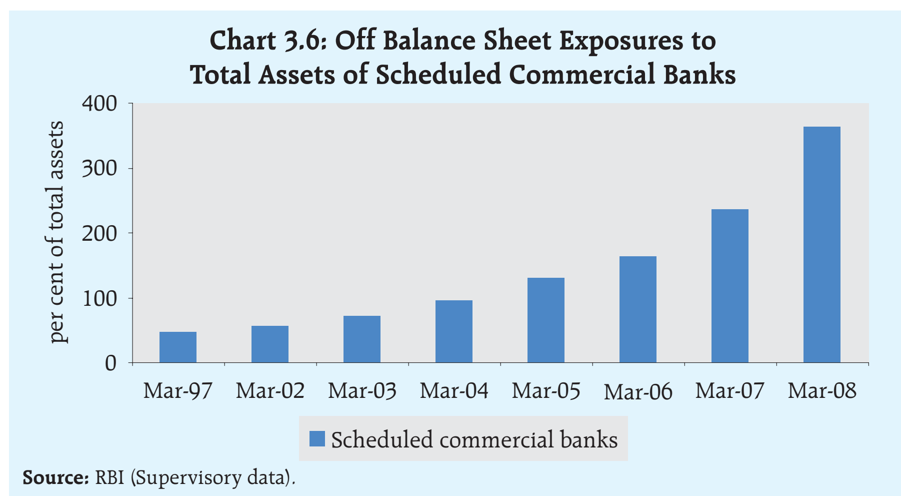
There has been significant improvement in cost, technical and allocative efficiency levels.

[3] Under the DEA approach, a best practice frontier which represents optimal utilisation level of resources is prepared and efficiency of banks is measured relative to that benchmark. For details of the analysis, see Report on Currency and Finance 2006-08.

A common indicator of banking solvency is the Z-score[4] in which a higher Z-score implies a lower probability of insolvency risk. Using this model, risk is summarised as the number of standard deviations an institution's earnings must drop below its expected value before equity capital is depleted (Cihak, *et al*). In other words $Z\text{-} \equiv (k+\mu)/\sigma$. Utilising this summarised identity, the Panel on Financial Stability Assessment and Stress Testing observed that the Z-score of commercial banks increased from 10.2 for period 1997-2006 to 13.2 for period 1999-2008 – an indication of increasing solvency.

Off-balance sheet (OBS) exposure has increased significantly in recent years, particularly in the case of foreign banks and new private sector banks. The notional principal amount of off-balance sheet exposure increased from Rs.8,42,000 crore at end-March 2002 to Rs.1,49,69,000 crore at end-March 2008. The ratio of OBS exposure to total assets increased from 57 per cent at end-March 2002 to 363 per cent at end-March 2008 (Chart 3.6). The spurt in OBS exposure is mainly on account of derivatives whose share averaged around 80 per cent. The derivatives portfolio has also undergone change with single currency IRS comprising 57 per cent of total portfolio at end-March 2008 from less than 15 per cent at end-March 2002 (Chart 3.7). The exposure in the case of PSBs has also recently shown an increase subsequent to the amendment in the SC(R) Act in 2003 allowing Over-The-Counter (OTC) transactions in interest rate derivatives. Further clarity in regulations of interest rate derivatives has been brought about by an amendment to the RBI Act, 1934 where a separate chapter III D (Section 45W) was incorporated that clarified the Reserve Bank's position in

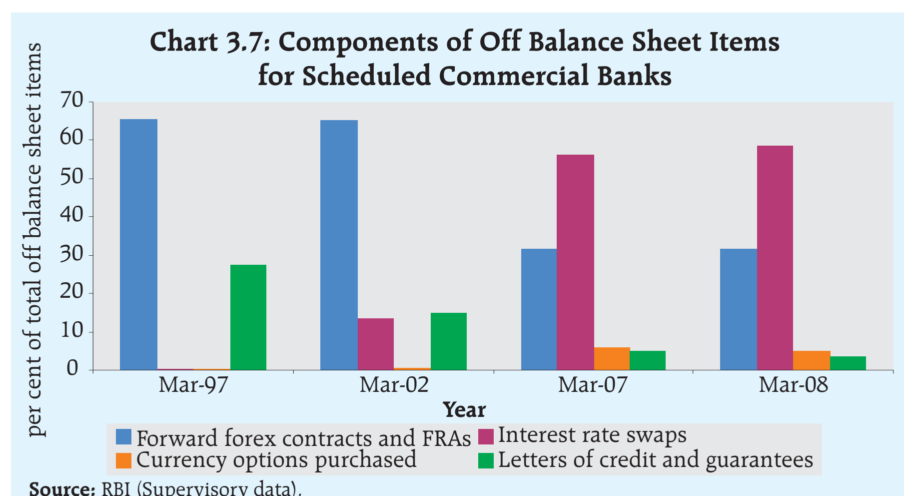
**Chart 3.6: Off Balance Sheet Exposures to Total Assets of Scheduled Commercial Banks**




**Source:** RBI (Supervisory data).

[4] Let $\mu$ = expected earnings (RoA), $\sigma \equiv$ standard deviation and $k \equiv$ capital to asset. Then Z-score $\equiv (k+\mu)/\sigma$ is the number of standard deviations below the mean earnings that just wipes out capital. Under standard economic theory, a firm trades off between higher expected earnings and lower variation in earnings along its $\mu$ -$\sigma$ efficient frontier, as well as choosing its capital k. Although this framework has its limits, it is useful to think of the contributions to risk in terms of factors that affect expected earnings (returns), the variation in earnings, capital and the institution's trade-off along the efficient risk-return frontier.

The spurt in OBS exposure is mainly on account of increase in derivatives.




**Source:** RBI (Supervisory data).

regulation of interest rate derivatives[5]. The current accounting standards do not clearly specify how to account for loss and profit arising out of derivatives transactions. The propensity of some corporate participants to use derivatives to assume excessive leverage coupled with the lack of prudential accounting and disclosure norms remains a significant concern[6] as this makes it difficult to gauge the quantum of market and credit risks that banks face in this regard. Mr. Andrew Sheng, the peer reviewer of the Advisory Panel report on Financial Stability and Stress Testing, agreed with the observations in the report that regulators should have a better understanding of the off-balance sheet liabilities of banks and that there should be better co-ordination with accounting standards and disclosures on whether such liabilities are likely to become on-balance sheet items. Centralised netting, collateral custody and a clearing system for derivatives would mitigate some of these risks. The CFSA notes that the recent sub-prime turmoil has highlighted the need to capture banks' off-balance sheet liabilities as well as the need to have a centralised netting mechanism to mitigate the risks arising from complex derivative products.

Regulators should have a better understanding of banks' off-balance sheet liabilities.

[5] Under Clause 45 (W) of the RBI Amendment Act, 2006, wherein the Reserve Bank has been given specific powers to 'regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products, and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time.'

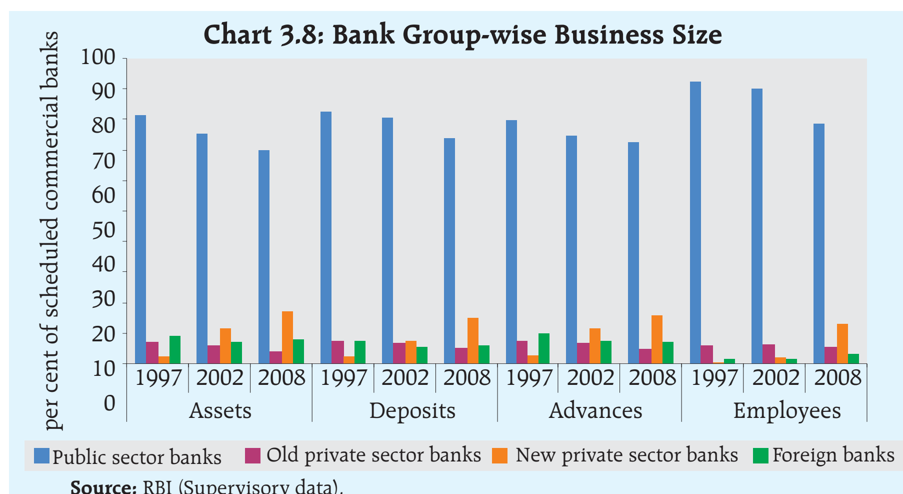
[6] In its effort to attain convergence with international accounting standards, the Institute of Chartered Accountants of India has issued AS 31 along the lines of IAS 32 (disclosures and presentation of financial instruments) and AS 30 along the lines of IAS 39 (recognition and measurements of financial instruments), which will be adopted for implementation on a voluntary basis effective April 1, 2009.

### 3.2.12 Bank Group-wise Analysis

*Business Size and Productivity*

The commercial banking sector is dominated by public sector banks (PSBs) which accounted for 70 per cent of commercial banking assets and nearly 80 per cent of employees at end-March 2008 (Chart 3.8).

**Chart 3.8: Bank Group-wise Business Size**




**Source:** RBI (Supervisory data).

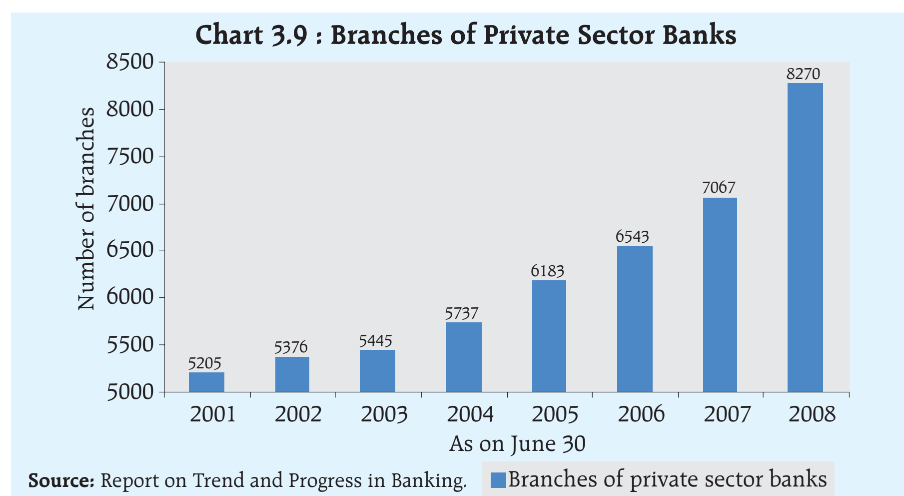
*Competition, Concentration and Efficiency*

The entry of private sector banks in the Indian banking sector has led to a decline in the market share of PSBs. New private sector banks grew at a very high rate and their market share grew to 17 per cent by 2008. Nevertheless, public sector banks appear to have responded to the new challenges of competition through greater operational flexibility. The CFSA in this context observes that in recent times there has been some discussion that the branch licensing policy could have restricted competition. Given the high growth of new private sector banks, it is arguable whether there could have been faster expansion without impairing the prudential quality and integrity of their balance sheets. The number of branches of private sector banks increased at a compounded rate of 6.8 per cent during the period June 30, 2001 to June 30, 2008 as against an increase of 2.1 per cent in the case of public sector banks during the corresponding period. The number of branches of private sector banks from 2001 to 2008 is furnished in the Chart 3.9.

It is arguable whether there could have been faster expansion of new private banks without impairing the prudential quality and integrity of their balance sheets.

The Herfindahl-Hirschman Index[7] for India (which was at 536 in 2008) indicates that the Indian banking sector is 'loosely concentrated'. A cross-country comparison of the concentration index shows that India's position is comparable with those of the advanced economies, but shows a lower concentration than other emerging market economies (Table 3.2).

[7] The Herfindahl-Hirschman Index (HHI) is defined as the sum of squares of market shares and varies between 0 and 10,000. In practice, markets in which HHI is below 1,000 are considered as 'loosely concentrated', between 1,000 and 1800 as 'moderately concentrated' and above 1800 as 'highly concentrated'.




**Source:** Report on Trend and Progress in Banking.

There has been a significant increase in productivity in terms of business per employee in the Indian banking system. This improvement is perhaps driven by two factors: technological improvements and 'a catching-up effect' where peer pressure among banks compels them to raise productivity levels.

The relatively higher productivity ratios of new private sector banks and foreign banks in terms of business per employee could be due to increased

**Table 3.2: Herfindahl-Hirschman Index**

| Country | 1998 | 2004 |
|---|---|---|
| **Advanced economies** | | |
| US | 117 | 157 |
| Germany | 245 | 283 |
| UK | 339 | 493 |
| Italy | 489 | 542 |
| France | 399 | 682 |
| Spain | 854 | 1188 |
| **Emerging market economies** | | |
| **India** | 720 | 536# |
| Malaysia | 1317 | 1334 |
| Chile | 974 | 1462$ |
| Mexico | 1542+ | 1529& |
| South Africa | 1310++ | 1840# |
| Brazil | 2164+ | 3352 |

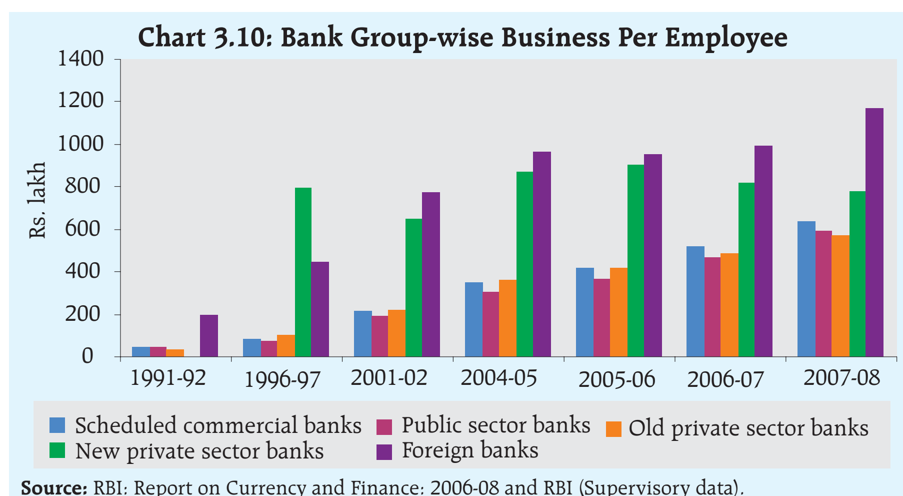
+ : For 2000 ++ : For 2001
$ : For 2002 & : For 2005
# : For 2008

**Source**: Report on Currency and Finance 2006-08 and RBI (Supervisory data).

There has been a significant increase in productivity in terms of business per employee in the Indian banking system.

mechanisation, lower staff strength and increased outsourcing activities as compared to public sector banks. Public sector banks have a legacy of labour-intensive work procedures and greater penetration in rural areas, which also result in comparatively low business per employee (Chart 3.10).

**Chart 3.10: Bank Group-wise Business Per Employee**




**Source:** RBI: Report on Currency and Finance: 2006-08 and RBI (Supervisory data).

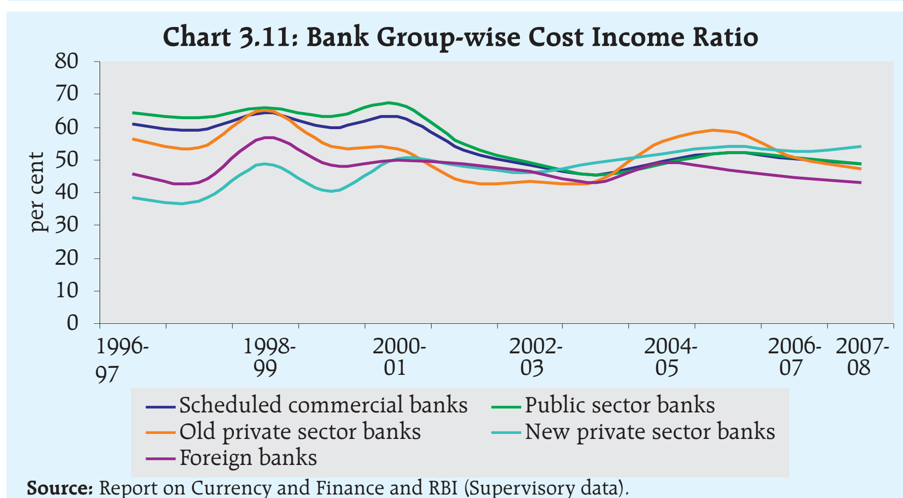
While the ratio of business per employee in PSBs and OPBs is lower than in NPBs and FBs, productivity as measured by the cost-income ratio, which takes into account the total non-interest expenses, does not show a significant divergence across bank groups (Table 3.3 and Chart 3.11).

**Table 3.3: Bank Group-Wise Productivity Indicators (2006 - 07)**

| | Cost-Income Ratio (per cent) | Business per Employee (Rs. lakh) | Labour cost per Unit of Earning Assets (per cent) | Non-Labour Cost per Unit of Earning Assets (per cent) |
|---|---|---|---|---|
| Scheduled Commercial Banks | 50.2 | 522 | 1.23 | 1.03 |
| Public Sector Banks | 50.6 | 471 | 1.32 | 0.73 |
| Old Private Sector Banks | 49.5 | 485 | 1.26 | 0.96 |
| New Private Sector Banks | 52.9 | 804 | 0.71 | 1.80 |
| Foreign Banks | 44.6 | 995 | 1.56 | 2.36 |

**Source**: Report on Trend and Progress in Banking: 2006-07 and Report on Currency and Finance: 2006-08.

**Chart 3.11: Bank Group-wise Cost Income Ratio**



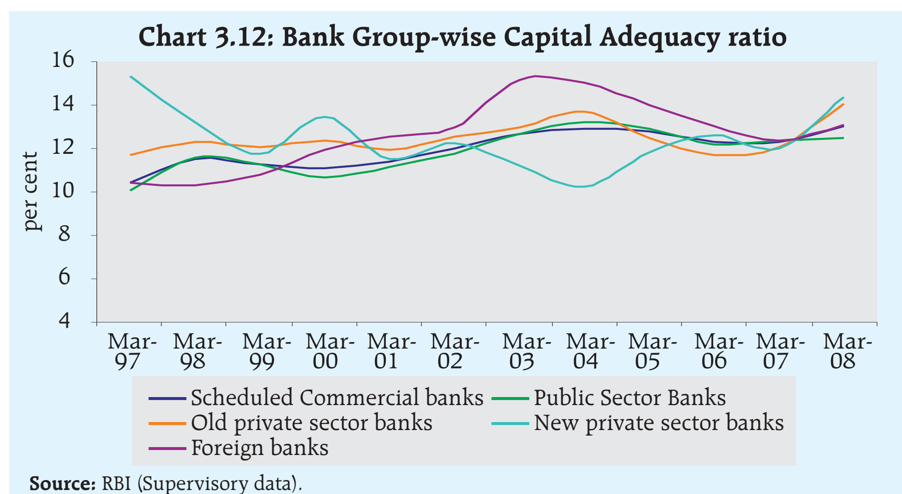

**Source:** Report on Currency and Finance and RBI (Supervisory data).

Capital Adequacy Ratio across bank groups remained generally comfortable.

*Capital Adequacy*

Capital adequacy ratios across bank groups remained generally comfortable at above 12 per cent between March 2005 and March 2008. Old private sector banks as a group showed a significant improvement between March 2006 and March 2008; this is subsequent to the merger of some weak banks with stronger banks in other segments (Chart 3.12).

**Chart 3.12: Bank Group-wise Capital Adequacy ratio**



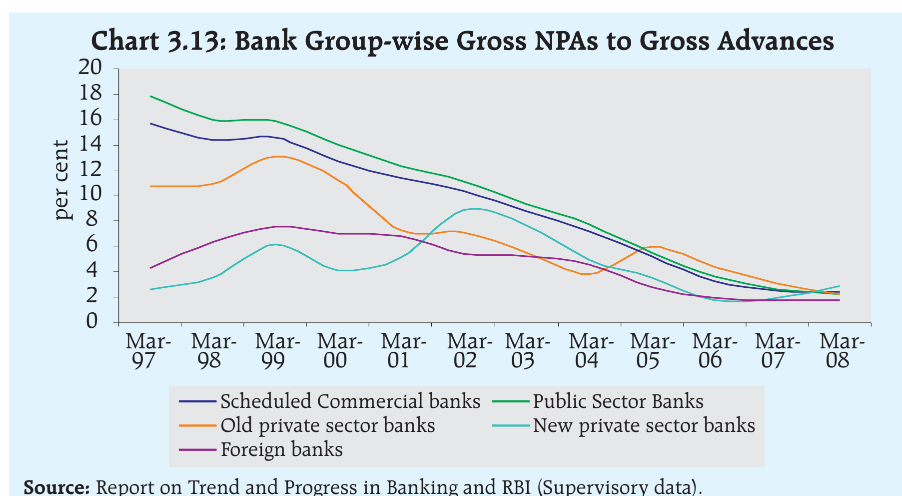

**Source:** RBI (Supervisory data).

*Asset Quality*

The NPA ratios of all bank groups has declined significantly in recent years (Charts 3.13 & 3.14).

NPA and asset slippage ratios show a declining trend across bank groups.

**Chart 3.13: Bank Group-wise Gross NPAs to Gross Advances**




**Source:** Report on Trend and Progress in Banking and RBI (Supervisory data).

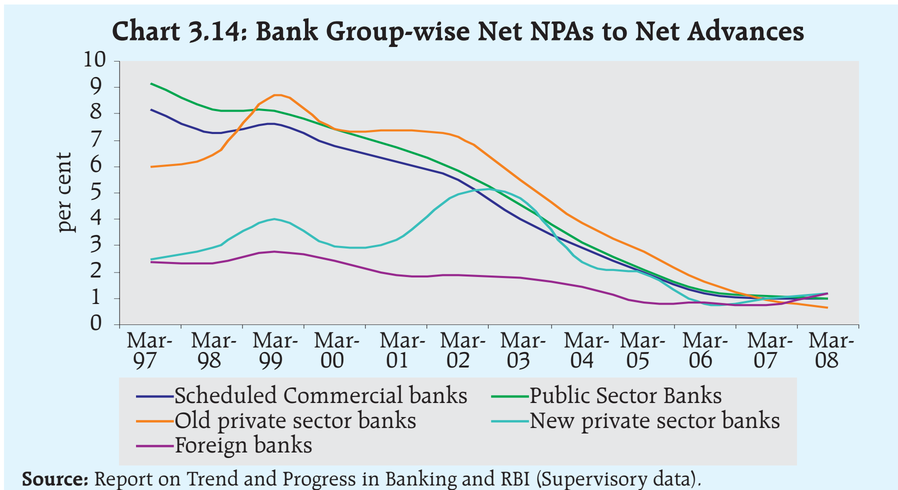



**Chart 3.14: Bank Group-wise Net NPAs to Net Advances**

**Source:** Report on Trend and Progress in Banking and RBI (Supervisory data).

The asset slippage ratio (defined as fresh slippages during the year/Gross NPAs at the beginning of the year[8]) also shows a declining trend (Chart 3.15).

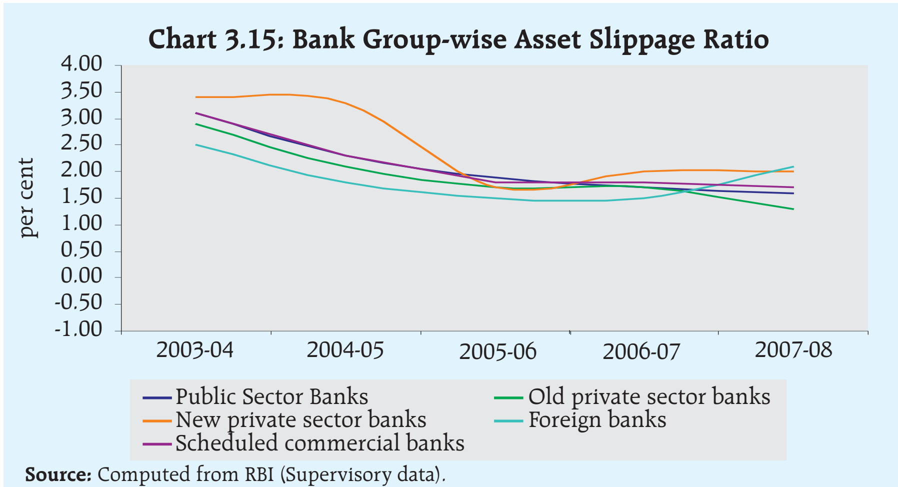



**Chart 3.15: Bank Group-wise Asset Slippage Ratio**

**Source:** Computed from RBI (Supervisory data).

The coverage ratio (defined as ratio of capital and reserves net of NPAs scaled by assets) has increased (Chart 3.16). This phenomenon can be seen

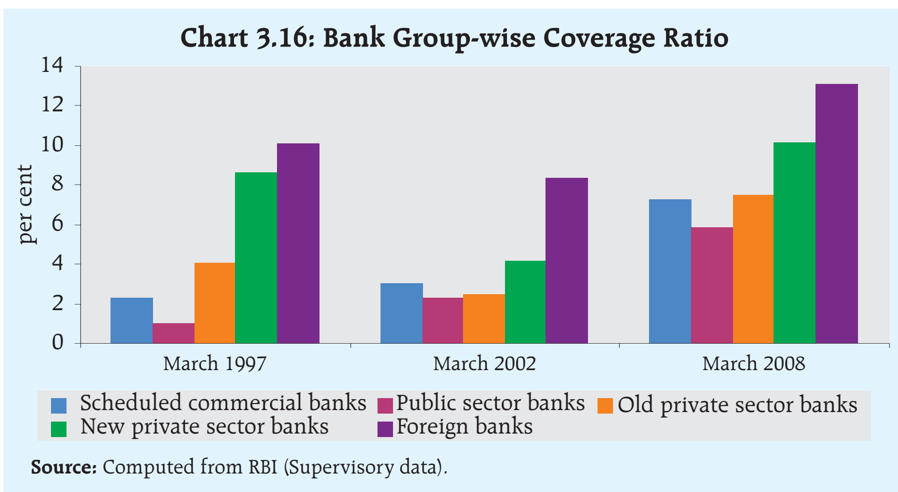



**Chart 3.16: Bank Group-wise Coverage Ratio**

**Source:** Computed from RBI (Supervisory data).

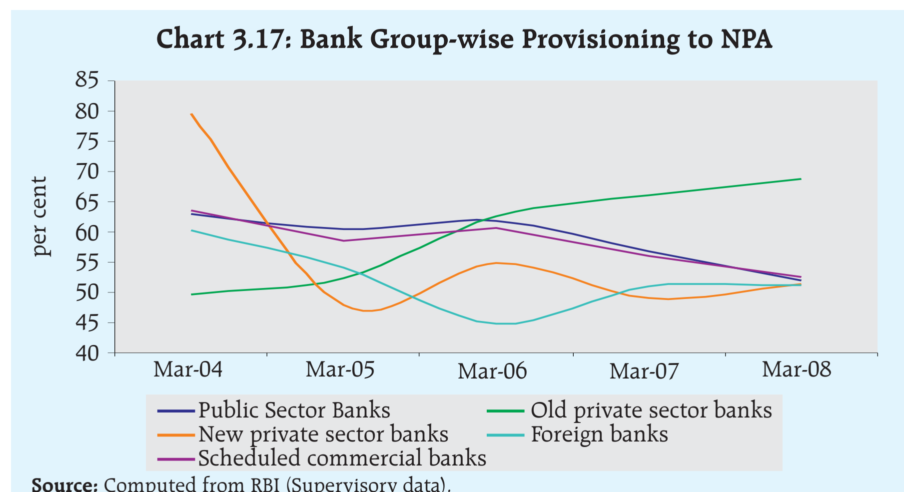
Coverage Ratio across bank groups have increased.

[8] Fresh slippage = NPA at the end of the year - NPA at the beginning of the year + amount recovered + amount upgraded + amount written off.

The increase in RoA was generally evident across bank groups.

across bank groups. The biggest improvement from negligible levels to nearly 6 per cent can be seen in public sector banks. The provisioning to NPA ratio hovers around 60 per cent for public sector banks (Chart 3.17).

**Chart 3.17: Bank Group-wise Provisioning to NPA**

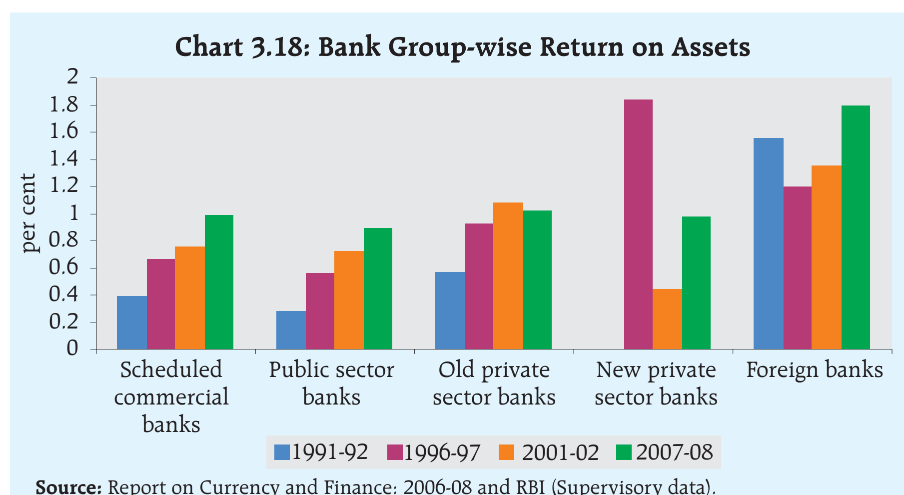



**Source:** Computed from RBI (Supervisory data).

*Earnings and Profitability*

The return on assets of the banks has shown marked improvement over the years. This is particularly evident in PSBs (Chart 3.18). The return on equity continues to hover between 10 to 15 per cent for SCBs (Chart 3.19).

**Chart 3.18: Bank Group-wise Return on Assets**

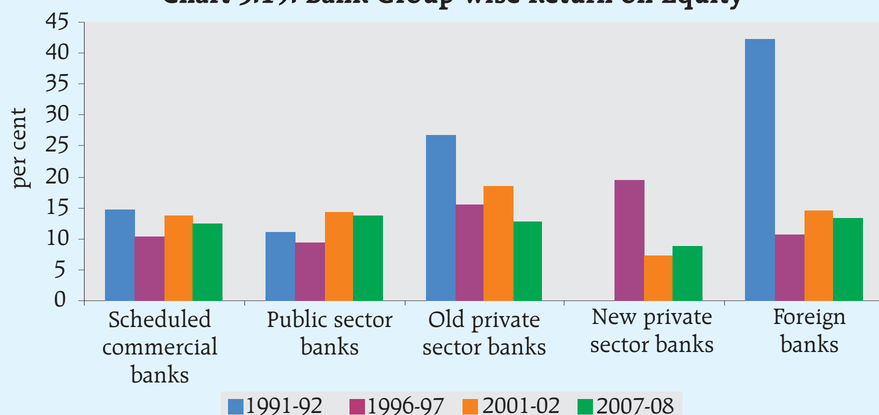



**Source:** Report on Currency and Finance: 2006-08 and RBI (Supervisory data).

Fee income has been contributing a significant portion of total income in respect of foreign banks and new private sector banks.

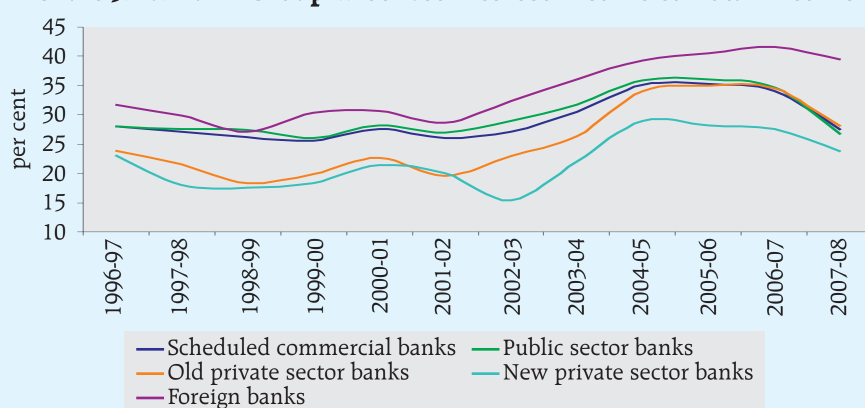
Although net interest income has remained the mainstay of banks, fee income has been contributing a significant portion to the total income of NPBs and FBs in recent years (Charts 3.20 & 3.21).

**Chart 3.19: Bank Group-wise Return on Equity**



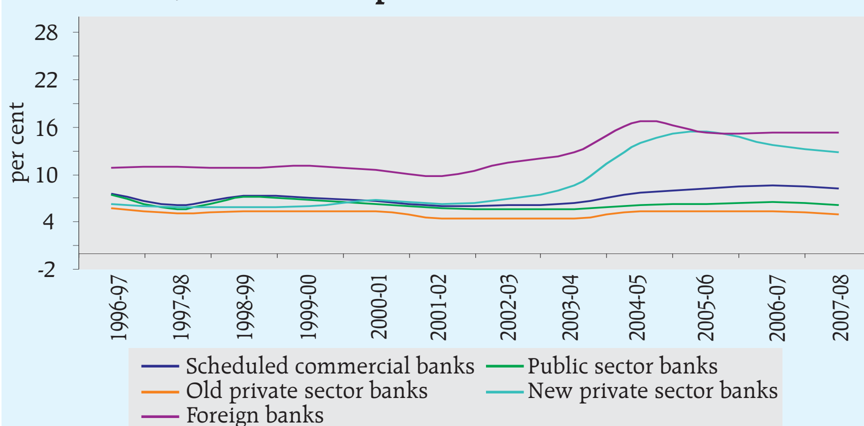

**Source:** Report on Currency and Finance: 2006-08 and RBI (Supervisory data).

**Chart 3.20: Bank Group-wise Net Interest Income to Total Income**




**Source:** RBI (Supervisory data).

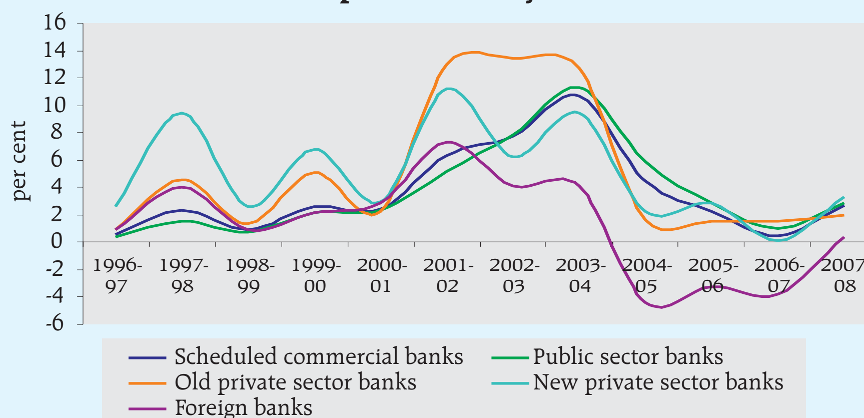
**Chart 3.21: Bank Group-wise Fee Income to Total Income**




**Source:** RBI (Supervisory data).

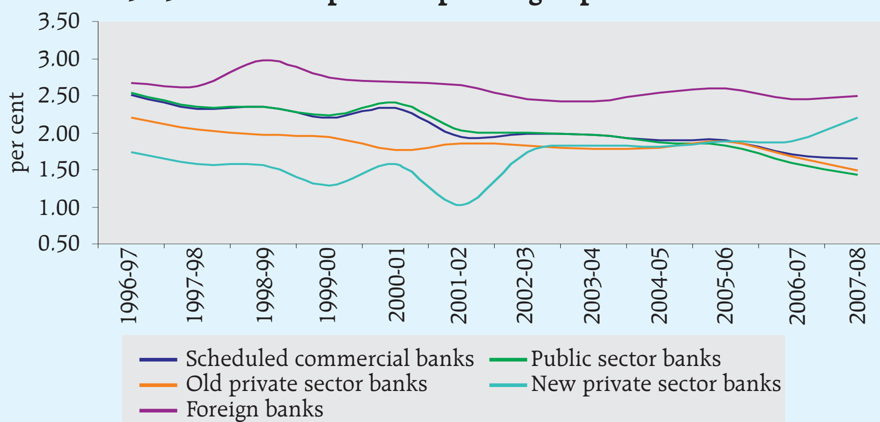
Treasury income, which was the second most important source of income until 2003-04, has declined to negligible levels due to the upturn in the interest rate cycle (Chart 3.22).

Operating expenses are showing moderation.




**Source:** RBI (Supervisory data).

Operating expense to assets of banks generally witnessed moderation across between 2003-04 and 2007-08, one of the reasons being a decline in the ratio of wage bill to total income (Chart 3.23).



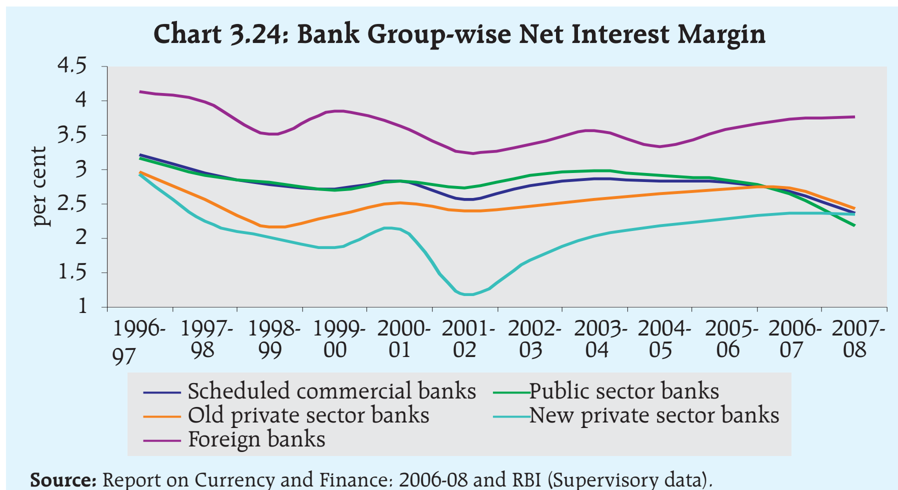

**Source:** Report on Currency and Finance and RBI (Supervisory data).

Net Interest Margins of PSBs have declined because of dependence on high-cost deposits.

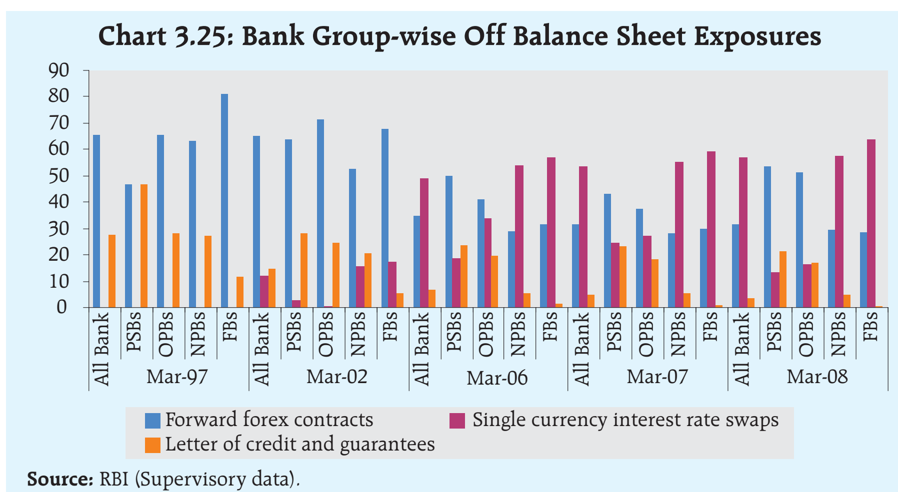
The net interest margin for PSBs showed a decline compared to an increase for other bank groups. This reflects the relative stickiness of lending rates and greater dependence on high-cost bulk deposits (Chart 3.24).

*Off-Balance Sheet Exposures*

The recent period has also seen significant diversity in derivatives products (Chart 3.25). This brings to the fore issues related to product appropriateness and capacity building. Strict adherence to product suitability




**Source:** Report on Currency and Finance: 2006-08 and RBI (Supervisory data).




**Source:** RBI (Supervisory data).

and user appropriateness policy[9] for derivatives products, as per the Reserve Banks stipulations remain a concern.

### 3.2.13 Financial Position of Commercial Banks in first half of 2008-09

The global financial meltdown has led to a crisis of confidence in the global markets and is not without its echo in the Indian financial system. In contrast to the trend observed till 2007-08, there has been a reversal in capital flows to India during 2008-09. This has led to some disturbance in the Indian financial markets, particularly in the equity and foreign exchange markets. Given this scenario, the CFSA decided to assess the financial soundness of commercial banks and found that the banking sector has withstood the

Strict adherence to product suitability and user appropriateness policy as regards derivatives remain a concern.

[9] The Reserve Bank has recently issued guidelines on derivatives which require the banks to have a suitability and appropriateness policy. The market-makers should carry out proper due diligence regarding 'user appropriateness' and 'suitability' of products before offering derivative products to users. Each market-maker should adopt a board-approved 'Customer Appropriateness and Suitability Policy' for the derivatives business. The objective of the policy is prudential in nature: to protect the market-maker against the credit, reputation and litigation risks that may arise from a user's inadequate understanding of the nature and risks of the derivatives transaction. In general, market-makers should not undertake derivative transactions with or sell structured products to users that do not have properly documented risk management policies that include, among other things, risk limits for various risk exposures.

shocks of the global meltdown well and none of the key financial parameters in September 2008[10] pointed to any discernable vulnerability as detailed below:

*Capital Adequacy*

While the CRAR and tier I ratio of banks have shown a marginal decline in respect of all the bank groups between March and September 2008, there does not appear to be any immediate cause for concern as the CRAR continues to remain well over the minimum regulatory requirement. Further, the tier I ratio is high and indicative of enough headroom for the banks to raise capital in the time of need (Table 3.4).

**Table 3.4: Capital Adequacy of Banks as at end-March and September 2008**

(Figures in per cent)

| | Scheduled Comm. Banks | | Public Sector Banks | | Old private Sector Banks | | New private Sector Banks | | Foreign Banks | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 |
| CRAR | 13.0 | 12.5 | 12.5 | 12.3 | 14.1 | 13.9 | 14.4 | 14.1 | 13.1 | 12.0 |
| Tier I | 9.1 | 8.8 | 7.9 | 7.7 | 11.8 | 11.8 | 10.8 | 10.7 | 11.3 | 10.5 |

**Source:** RBI (Supervisory Data)

*Asset Quality*

The asset quality of the banks has remained intact as evident from the low NPA ratios. Within bank groups however, there has been some increase in

**Table 3.5: Asset Quality of Banks as at end-March and September 2008**

(Figures in per cent)

| | Scheduled Comm. Banks | | Public Sector Banks | | Old Private Sector Banks | | New Private Sector Banks | | Foreign Banks | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 |
| Gross NPAs | 2.4 | 2.3 | 2.3 | 2.1 | 2.3 | 3.4 | 2.9 | 2.3 | 1.7 | 2.1 |
| Net NPAs | 1.0 | 1.1 | 1.0 | 0.9 | 0.7 | 1.5 | 1.2 | 0.8 | 1.2 | 1.0 |
| Asset slippage* | 1.7 | 1.8 | 1.6 | 1.4 | 1.3 | 1.9 | 2.0 | 2.3 | 2.1 | 3.6 |
| Provisioning to NPL | 52.5 | 65.5 | 51.9 | 60.0 | 68.8 | 74.5 | 51.4 | 79.4 | 51.2 | 68.3 |

* Figures Annualised for April-September 2008.
**Source:** RBI (Supervisory Data)

Capital adequacy of banks as at end-September 2008 does not show any immediate cause of concern.

[10] The CFSA notes that the financial soundness indicators for December 2008 do not show much variance from the September 2008 levels.

NPA ratios in respect of the old private and foreign banks (Table 3.5). The increase in asset slippage (on an annualised basis) during the half year March-September 2008 has been quite pronounced in respect of all bank groups other than public sector banks. Taking cognisance of the increased asset slippage ratio, the level of provisioning has increased across bank groups. While increased provisioning has not impacted profitability very significantly for the first half of 2008-09, it could impact the banks' profitability going forward.

Asset quality of banks remained intact.

*Earnings and Profitability*

While there has been no major variation in the annualised RoA and RoE across bank groups during the half year April-September 2008 when compared to 2007-08, the banks have suffered a loss in their trading operations. Net interest margin (annualised) has, however, increased during April-September 2008 pointing to a rising interest rate scenario during this period. (Table 3.6).

**Table 3.6: Earnings and Profitability of Banks as at end-March and September 2008**

(Figures in per cent)

| | Scheduled Comm. Banks | | Public Sector Banks | | Old Private Sector Banks | | New Private Sector Banks | | Foreign Banks | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2007-08 | Apr-Sep'08 | 2007-08 | Apr-Sep'08 | 2007-08 | Apr-Sep'08 | 2007-08 | Apr-Sep'08 | 2007-08 | Apr-Sep'08 |
| RoA* | 1.0 | 0.9 | 0.9 | 0.8 | 1.0 | 1.0 | 0.9 | 1.0 | 1.8 | 1.8 |
| RoE* | 12.5 | 12.0 | 13.7 | 12.4 | 12.9 | 12.1 | 8.9 | 9.0 | 13.5 | 14.7 |
| NII to total income | 27.4 | 28.1 | 26.7 | 26.4 | 28.1 | 29.0 | 23.7 | 27.2 | 39.5 | 40.5 |
| Treasury income to total income | 2.7 | -0.6 | 2.9 | 1.7 | 2.0 | 1.3 | 3.3 | -2.9 | 0.4 | -12.7 |
| Fee income to total income | 8.2 | 7.7 | 6.1 | 5.0 | 4.9 | 5.0 | 12.8 | 14.9 | 15.3 | 14.4 |
| Operating costs to total assets* | 1.8 | 1.8 | 1.6 | 1.6 | 1.7 | 1.7 | 2.5 | 2.5 | 2.8 | 2.6 |
| NIM* | 2.4 | 2.6 | 2.2 | 2.3 | 2.4 | 2.8 | 2.4 | 2.9 | 3.8 | 3.7 |

* Figures for April-September 2008 annualised.
** Income from securities trading.
**Source:** RBI (Supervisory Data).

*Off Balance Sheet Exposure*

The ratio of OBS exposure to total assets remained at the same level in September 2008 as compared to March 2008. The decline in the OBS ratios in respect of new private and foreign banks was compensated to a large extent by the increase in the OBS ratio of PSBs and old private banks (Table 3.7).

Though RoA remained at similar levels, banks suffered a loss in their treasury operations.

**3.2.2 Resilience**

The resilience of the financial system can be tested by subjecting the system to stress scenarios. While ideally stress scenarios should also be linked with a macroeconomic framework, in the absence of adequate data to link macroeconomic scenarios with financial soundness indicators and also the

**Table 3.7: Off-balance Sheet Exposure of Banks as at end-March and September 2008**

| | Scheduled Comm. Banks | | Public Sector Banks | | Old Private Sector Banks | | New Private Sector Banks | | Foreign Banks | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 |
| OBS exposure | 364.0 | 356.0 | 57.8 | 60.0 | 56.8 | 63.9 | 311.3 | 286.9 | 3028.4 | 2591.4 |

Figures as per cent of total assets
**Source:** RBI (Supervisory Data)

| | Scheduled Comm. Banks | | Public Sector Banks | | Old Private Sector Banks | | New Private Sector Banks | | Foreign Banks | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 | Mar-2008 | Sep-2008 |
| Forward forex contracts | 31.64 | 38.53 | 53.27 | 62.33 | 51.44 | 54.96 | 29.19 | 39.78 | 28.65 | 34.50 |
| Single currency IRS | 56.89 | 49.88 | 13.44 | 4.28 | 16.48 | 16.67 | 57.65 | 47.51 | 63.69 | 57.63 |
| LCs | 1.61 | 2.00 | 10.53 | 13.05 | 7.97 | 8.24 | 1.79 | 2.45 | 0.17 | 0.16 |
| Guarantees | 2.04 | 2.35 | 11.03 | 12.06 | 8.80 | 7.70 | 2.99 | 4.26 | 0.44 | 0.50 |

Figures as per cent of total off-balance sheet exposures
**Source:** RBI (Supervisory Data)

absence of any stress events in the Indian financial system for the past 15 years, the current assessment has used single factor sensitivity analysis to assess the resilience of the financial system to exceptional, but plausible, stress events.

In the absence of adequate data and any historical 'stress' events, single factor stress tests have been used in the current assessment.

Single factor stress tests are undertaken by subjecting the balance sheet or any other parameter of an institution to an exogenous and instantaneous shock at a given point of time *ceteris paribus*. These tests do not take into account second-round effects and systems adjustment to these shocks over time. To test systemic resilience, stress tests for the commercial banking sector covering credit risk, market risk and liquidity risk were carried out by the Advisory Panel on Financial Stability Assessment and Stress Testing. The CFSA notes that stress testing needs to take into account co-related risks, *i.e.*, simultaneous occurrence of two to three problems; however, limitations of availability of data and a model has precluded the Committee from doing such an analysis. However, it notes that as a way forward there is need for developing such an analysis over a period of time.

All analyses were carried out both at the aggregate level as well as at the individual bank level, based on supervisory data for March 2006, 2007 and 2008. While the detailed analysis and the results of the stress tests are available in the Panel Report on Financial Stability Assessment and Stress

Testing (Vol. III, Chapter II), the summary findings and the major strengths or risks that were brought out by the tests are given below.

**3.2.21 Credit Risk**

Stress testing for credit risk was carried out by increasing both the NPA levels and provisioning requirements for standard, substandard and doubtful assets. The analysis was carried out both at the aggregate level and individual bank level for end-March 2008 under three scenarios. The first scenario assumes a 25 per cent and a 50 per cent increase in NPAs. Given that there is a possibility of an increased deterioration of credit quality due to global financial meltdown and its impact on the Indian corporate sector, at the instance of CFSA, the NPA shocks imparted were further increased to 100 and 150 per cent. The shock imparted in the second scenario amounts to the maximum asset slippage experienced by banks since 2001. The third scenario assumes a 50 per cent increase in retail NPAs. The results obtained from each stress scenario were then related to regulatory capital to assess the resilience of commercial banks, both at the system level and for individual banks. The results of the stress tests are summarised in Table 3.8.

**Table 3.8: Stress Tests of Credit Risk – Scenarios and Results – Position with reference to March 31, 2008**

| | Without stress | Scenario I - Increase in NPAs | | | | | | | | Scenario II | | Scenario III | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 25% | | 50% | | 100% | | 150% | | | | | |
| | | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* |
| All banks | 13.0 | 12.3 | 5 | 12.1 | 5 | 11.6 | 8 | 11.0 | 12 | 11.6 | 15 | 12.6 | 2 |
| Nationalised | 12.1 | 11.4 | 2 | 11.1 | 2 | 10.5 | 3 | 9.9 | 5 | 10.4 | 6 | 11.6 | 1 |
| SBI Group | 13.2 | 12.1 | 0 | 11.8 | 0 | 11.1 | 0 | 10.4 | 0 | 11.7 | 2 | 12.4 | 0 |
| New Private | 14.4 | 14.1 | 0 | 13.9 | 0 | 13.5 | 1 | 13.1 | 2 | 13.8 | 2 | 14.3 | 0 |
| Old Private | 14.1 | 13.2 | 2 | 12.9 | 2 | 12.2 | 3 | 11.5 | 4 | 12.1 | 4 | 13.5 | 1 |
| Foreign | 13.1 | 12.9 | 1 | 12.8 | 1 | 12.7 | 1 | 12.5 | 1 | 12.2 | 1 | 13.0 | 0 |

CRAR in per cent.
* : Number of banks whose CRAR would fall below 9 per cent due to the shock.
**Source :** RBI (Supervisory Data).

Under Scenario I, when NPA levels were assumed to increase by 25 per cent, the CRAR for the entire banking system reduced to 12.3 per cent from the existing 13.0 per cent in March 2008. If the NPA levels were stressed by a 50 per cent increase, the CRAR would reduce to 12.1 per cent. The corresponding figures of system level CRAR for 100 per cent and 150 per cent shocks were 11.6 and 11.0 per cent respectively. Before the stress test, all banks were found to be able to meet the regulatory stipulation of 9 per cent in March 2008. However, in the case of an increase in NPAs by 25 per cent, the CRAR of a total of five banks would fall below 9 per cent and, in the case of an increase in NPAs by 50 per cent, the CRAR of the same five banks would continue to remain below 9 per cent. If the NPAs witness a 100 per cent increased CRAR of eight banks will go below the regulatory minimum. In case of a 150 per cent shock 12 banks will not be able to meet the regulatory stipulation.

In order to simulate the effect of an economic slowdown on the banks' advances portfolio, the maximum asset slippage experienced by banks

between 2001 and 2008 was applied to the stock of gross loans under Scenario II. The system-level CRAR declined to 11.6 per cent after application of the shock. A total of 15 banks would have a CRAR below 9 per cent in the altered scenario.

In the recent past, the increase in credit portfolio of the banks was driven to a large extent by expansion in retail credit. Keeping this in view, Scenario III stressed the retail segment by increasing the NPAs of retail loans by 50 per cent. The system-level CRAR in this case reduced to 12.6 per cent. A total of two banks would have a CRAR below 9 per cent. Credit risk for the retail sector is low at present but continuous monitoring is required.

Given that even in the worst-case scenario the CRAR remains well above the regulatory minimum, the CFSA concluded that the impact of stress on the credit portfolio of banks is relatively muted. At the same time, although credit risk concerns remain low at present, there is need for closer and continuous monitoring of such risks in order to avoid any possibilities of significant asset quality deterioration over the medium term.

**3.2.22 Market Risk**

The resilience of banks to market risk was measured by assessing the impact on their capital and income due to interest rate shocks and fall in equity prices.

*Interest rate risk*

Interest rate risk stress tests were undertaken using both earnings at risk (EaR) or short-term perspective as also the economic value perspective. In the EaR perspective, the focus of analysis is the impact of changes in interest rates on accrual or reported earnings. Changes in interest rates impact a bank's earnings due to changes in interest income and the level of other interest-sensitive income and expenses. In the EaR approach, the impact of change in earnings due to changes in interest rates is related to net interest income (NII). Applying the EaR approach[11], it was observed that the NII increases for 45 banks comprising 64 per cent of the banking assets for an increase in interest rates. This is because, typically, the banks' balance sheets are asset sensitive and an increase in interest rate raises the interest income relative to interest expenses.

Credit risk for the sector is low but continuous monitoring is needed.

[11] The EaR approach involves classifying the interest rate sensitive assets and interest rate liabilities into various time buckets and working out EaR based on the bank's views on interest rate movements and fix a prudent level with the approval of the board/management committee.

Variation in market interest rates can also affect the economic value of a bank's assets, liabilities, and off-balance sheet (OBS) positions. The economic value of an instrument represents an assessment of the present value of its expected net cash flows that is discounted to reflect market rates. By extension, the economic value of a bank can be viewed as the present value of the bank's expected net cash flows, which is defined as the expected cash flows on assets minus the expected cash flows on liabilities plus the expected net cash flows on OBS positions. In this sense, the economic value perspective reflects one view of the sensitivity of the net worth of the bank to fluctuations in interest rates. The stress test from the economic value perspective was attempted from two standpoints. In the first instance, the duration of equity[12] was worked out for the balance sheet and the erosion of net worth for a given increase in interest rate based on the estimated yearly yield volatility was arrived at. The interest rate risk was also estimated from the standpoint of loss in economic value for the banks' balance sheet and OBS exposures due to an increase in interest rate. Based on the estimated yearly yield volatility, the impact was related to regulatory capital to assess the resilience. While both approaches were used to assess the resilience of the banks' balance sheets, the second approach was additionally adopted to assess the impacts of interest rate shocks on the banking and trading book separately.

The analysis of interest rate risk from the economic value perspective has been conducted under two scenarios. In scenario I the entire rate sensitive savings deposits are assumed to mature between 1-28 days. In scenario II the entire rate sensitive savings deposits are assumed to mature in 3 to 6 months time band.

It was observed that between March 2007 and 2008 the duration of equity reduced from 12 years to eight years, a pointer to better management of interest rate risk by banks. Yield volatility was estimated at 244 basis points (bps) for a one-year holding period. A 244 bps increase in yield, *ceteris paribus*, would result in an erosion of 19.5 per cent of capital and reserves. From the economic value perspective, the CRAR would reduce to 10.9 per cent (11.1 under Scenario II) for a 244 bps shock. The CRAR of 29 banks that account for 35.7 per cent of the total commercial banks' assets (28 banks accounting for 35.0 per cent under Scenario II) would go below 9 per cent under Scenario I (Table 3.9).

Currently, all the banks' investment portfolios are divided into three categories, *viz.*, held to maturity (HTM), held for trading (HFT) and available for sale (AFS). The Reserve Bank's decision in September 2004 permitting banks to shift securities from the HFT and AFS categories to HTM to the extent of their mandated SLR has resulted in an increase in the HTM portfolio of banks. The trading portfolio in the case of investments comprises investments in AFS and HFT. As per extant accounting norms, banks are

Banks have started managing interest rate risk better. Duration of equity has come down.

[12] Duration of equity is the rate at which the net worth of a bank is impacted due to a unit percentage increase in bank rate. It is also known as net worth duration.

**Table 3.9: Stress Test on Balance Sheet (Economic Value Perspective) – March 2008**

| CRAR ( per cent) | Interest Rate Shock | | | |
|---|---|---|---|---|
| | 100 bps | 200 bps | 244 bps | 300 bps |
| **Scenario I** | Savings deposits assumed to mature in 1-28 days bucket | | | |
| System Average | 12.1 | 11.3 | 10.9 | 10.4 |
| No. of banks below regulatory minimum | 4 (4.2) | 20 (25.9) | 29 (35.7) | 33 (40.4) |
| **Scenario II** | Savings deposits assumed to mature in 3-6 months | | | |
| System Average | 12.2 | 11.4 | 11.1 | 10.6 |
| No. of banks below regulatory minimum | 3 (2.2) | 18 (22.4) | 28 (35.0) | 32 (38.3) |

**Note**: Figures in parentheses indicate the per cent of total assets.
**Source :** RBI (Supervisory Data).

required to mark to market only their trading portfolio. As a result, a significant portion of banks' investment portfolios are insulated from interest rate risk. While this disregard of interest rate risk in the banking book could make banks vulnerable to embedded losses, the actual impact on capital due to interest rate increase is expected to be lower than what has been estimated.

The Panel estimated that an interest rate shock of 244 bps on the banks' trading book would reduce the systemic CRAR to 12.0 per cent, whereas it would have been reduced to 10.9 per cent if the entire balance sheet was marked to market (Table 3.10).

**Table 3.10: Impact on Trading Book* (Economic Value Perspective) – March 2008**

| CRAR ( per cent) | Interest Rate Shock | | | |
|---|---|---|---|---|
| | 100 bps | 200 bps | 244 bps | 300 bps |
| System Average | 12.6 | 12.2 | 12.0 | 11.7 |
| No. of banks below regulatory minimum | 1(0.1) | 4(3.8) | 9 (8.3) | 9(8.3) |

* : A trading book or portfolio refers to the book of financial instruments held for the purpose of short-term trading, as opposed to securities that would be held as a long-term investment. The trading book refers to the assets that are held primarily for generating profit on short-term differences in prices/yields. The price risk is the prime concern of banks in trading book.
**Note :** Figures in parentheses indicate the per cent of total assets
**Source :** RBI (Supervisory Data).

A significant portion of banks' investment portfolios is insulated because of the existing accounting norms.

Similarly, a 244 bps rise in interest rates, if applied only to the banking book, would result in the CRAR being reduced from 13.0 per cent to 11.9 per cent under Scenario I (12.1 per cent under Scenario II) in March 2008 (Table 3.11).

| Table 3.11: Impact on Banking Book* (Economic Value Perspective) – March 2008 | | | | |
|---|---|---|---|---|
| **Range of CRAR ( per cent)** | **100 bps** | **200 bps** | **244 bps** | **300 bps** |
| **Scenario I** | Savings deposits assumed to mature in 1-28 days bucket | | | |
| System Average | 12.6 | 12.1 | 11.9 | 11.7 |
| No. of banks below regulatory minimum | 1(1.2) | 11 (10.3) | 16 (17.5) | 22 (29.4) |
| **Scenario II** | Savings deposits assumed maturing in 3-6 months | | | |
| System Average | 12.6 | 12.3 | 12.1 | 11.9 |
| No. of banks below regulatory minimum | 0(0.0) | 10 (10.2) | 12 (12.6) | 17 (22.0) |

* : The banking book comprises assets and liabilities, which are contracted basically on account of relationship or for steady income and statutory obligations and are generally held till maturity.

**Note**: Figures in parentheses indicate the per cent of total assets
**Source :** RBI (Supervisory Data).

*Equity Price Risk*

Banks exposure to capital market including direct equity exposure remains low. Looking to the sharp decline in share prices in the recent past, a stress test for a diminution in market value of share prices to the extent of 80 per cent was considered by CFSA. It was observed that as at end-March 2008, the above stress test would result in CRAR declining from 13.0 per cent to 12.0 per cent. The equity price risk in respect of commercial banks, therefore, remained low.

The equity price risk in respect of commercial banks remained low.

### 3.2.23 Liquidity Risk

Until 2004, banks in India had a comfortable liquidity position in view of their large holdings of government securities, which was much in excess of the then statutory requirement of 25 per cent. However, the momentum of credit growth witnessed by banks subsequent to 2004 was partially effected by the reshuffling of banks' assets portfolio by shifting investments in favour of loan assets. This lowered eligible investments from over 40 per cent of Net Demand and Time Liabilities in the early 2000s to 27.8 per cent as at end-March 2008. The Panel carried out its assessment of liquidity risk facing the commercial banking sector from three angles: analysis of select liquidity ratios, asset liability mismatch and scenario analysis of liquidity risk.

*Liquidity Ratios*

Typically, banks can meet their liquidity needs by two methods: stored liquidity and purchased liquidity. Stored liquidity uses on-balance sheet liquid assets and a well-crafted deposit structure to provide all funding needs. Purchased liquidity uses non-core liabilities and borrowings to meet funding needs. (Hanson, 2003) While dependence on stored liquidity is considered to be safer from the liquidity risk perspective, it has cost implications. A balanced approach to liquidity strategy in terms of dependence on stored and purchased liquidity is the most cost-effective and optimal risk strategy.

To assess the banking sector's funding strategy and the liquidity risk emanating from there, a set of liquidity ratios has been developed and analysed in detail[13]. There has been a gradual and growing dependence of the system on purchased liquidity coupled with an increase in the illiquid component of balance sheets, such as a greater reliance on large and volatile liabilities to support asset growth (Table 3.12). Extensive dependence on purchased liquidity may expose a bank to liquidity problems as they are more sensitive both to changes in bank-specific risks and interest rate risk. Mr. Sundararajan, peer reviewer, felt that in view of the growing use of purchased funds to support asset expansion, an analysis of second-round contagion effects by stress testing the data matrix on bilateral inter-bank exposures requires to be developed. The Panel has accepted his suggestion and felt efforts must be made to build up the database to assess the contagion risk.

**Table 3.12: Liquidity Ratios – Average Value**

| Ratio | Mar-05 | Mar-06 | Mar-07 | Mar-08 |
|---|---|---|---|---|
| (Volatile Liabilities* – Temporary Assets**)/ (Earning Assets^ –Temporary Assets) (per cent) | 34.7 | 38.4 | 41.4 | 43.9 |
| (Core Deposits@)/Total Assets (per cent) | 53.8 | 53.9 | 52.2 | 49.3 |
| (Loans + Mandatory CRR + Mandatory SLR + Fixed Assets)/Total Assets (per cent) | 75.0 | 79.9 | 83.4 | 86.3 |
| (Loans + Mandatory CRR + Mandatory SLR + Fixed Assets)/Core Deposits | 1.4 | 1.5 | 1.6 | 1.8 |
| Temporary Assets/Total Assets (per cent) | 28.8 | 30.3 | 43.4 | 52.0 |
| Temporary Assets/Volatile Liabilities | 0.54 | 0.53 | 0.65 | 0.71 |
| Volatile Liabilities/Total Assets (per cent) | 53.5 | 57.1 | 66.8 | 73.1 |
| (Market value of Non-SLR Securities + Excess SLR Securities)/(Book Value of Non-SLR Securities and Excess SLR Securities) | 1.0 | 1.1 | 0.98 | 1.0 |

* : Volatile liabilities: Deposits + borrowings + bills payable up to 1 year.

** : Temporary assets: Cash + excess CRR balances with the Reserve Bank + balances with banks + bills purchased/discounted up to 1 year + investments up to 1 year + swap funds (sell/buy) up to one year.

^ : Earning assets: Total assets - (Fixed assets + balances in current accounts with other banks + other assets excluding leasing + intangible assets).

@ : Core Deposits: All deposits (including current and savings account) above 1 year + net worth.

**Source :** RBI (Supervisory Data).

There has been a gradual and growing dependence of the system on purchased liquidity coupled with an increase in the illiquid component of balance sheets.

[13] For a detailed analysis of the ratios, see Volume III - Advisory Panel Report on Financial Stability Assessment and Stress Testing.

The analysis of the above ratios for the period 2005-08 revealed that:

(i) The increase in the ratio of volatile liabilities net of temporary assets to earning assets net of temporary assets indicates greater reliance on volatile liabilities to support asset growth.

(ii) The reduction in the ratio of core deposits plus net worth to total assets indicates a reducing share of stable funding sources and a greater reliance on short-term deposits and borrowings by banks.

(iii) The increase in the ratio of loans including fixed assets, mandatory Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) prescriptions to total assets is reflective of increasing illiquidity due to increase in loan assets.

(iv) The increase in the ratio of loans including fixed assets, mandatory CRR and SLR prescriptions to core deposits plus net worth reflected greater dependence on purchased liquidity by the banks.

(v) The increase in the ratio of temporary investments to earning assets indicates relative increase in short-term assets to earning assets.

(vi) Despite a rise in temporary investments, it was not sufficient to cover large liabilities, thereby reflecting a potential liquidity problem.

(vii) The increase in the ratio of volatile liabilities to total assets indicates higher reliance on such liabilities to fund asset growth.

(viii) The ratio of market value of non-SLR securities and surplus SLR securities to their book values stood at one in March 2008.

*Asset Liability Mismatch*

The maturity profile of deposits, advances and investments of the banking system reveals that since March 2001 there has been a steady rise in the proportion of short-term deposits maturing up to one year. Deposits maturing up to one year increased from 33.2 per cent in March 2001 to 43.6 per cent in March 2008. At the same time, the share of term loans maturing beyond five years increased from 9.3 per cent to 16.5 per cent. While this could imply increased profits, the increased asset liability mismatch has increased the liquidity risk faced by banks.

*Scenario Analysis*

Three scenarios were constructed to analyse the resilience of the five largest commercial banks based on their asset size as of March 2008 in the event of a large liquidity drain over a short period of time. The first scenario captures unexpected deposit withdrawals on account of sudden loss of depositor confidence and adequacy of liquid assets to fund them. The withdrawals are expected to continue for five days. The second scenario segregates unexpected withdrawals between uninsured and insured deposits. It is assumed that uninsured depositors are the first to adopt the flight to quality and withdraw their deposits. Consequently, the rate of withdrawal by uninsured depositors is higher than that by insured

There has been an increase in asset liability mismatch in the banks' books.

depositors. The final scenario envisages crystallisation of contingent credits/ commitments as a result of changes in credit risk profile and increase in delinquency in repayment of loans. The impact is then assessed by estimating the adequacy of liquid assets to meet the funds crunch.

The conclusions are:

- Under Scenario I, one bank ends up with marginal negative balance from first day, two more banks end up with negative balance at end of third day.
- Under Scenario II, of the five top banks, one bank faces liquidity strain from second day and two banks exhibit liquidity strains from the third day onwards; and
- Under Scenario III, barring one bank, the other banks are able to meet the devolvement of their contingent liabilities at the end of six months.

Thus, the results of the stress tests show that the liquid assets of the select banks are generally sufficient to withstand unexpected deposit withdrawals for one day if retail depositors lose confidence in the banks. If deposit insurance is assumed to provide a sense of comfort to retail deposits, the impact is relatively lower on account of the high retail deposit base of the banks. In addition, the following factors merit attention:

- The stress tests for liquidity assess the immediate impact of a one-time shock.
- The banks are assumed to meet their liabilities entirely by using only their stock of liquid assets.
- The banks are not assumed to use their investments and other assets which are not included in the definition of liquid assets.
- The banks are not assumed to tap the money market or invoke committed lines of credit extended by other banks.
- There is no intervention by the Central Bank of the country via LoLR or other rescue measures.

Considering the above assumptions, it can be concluded that the liquidity position of systemically important banks is generally comfortable and able to withstand any unexpected withdrawals in the short term. However, considering the increasing reliance on purchased liquidity, there is a

The scenario analysis shows the liquid assets of the selected banks generally are sufficient to withstand unexpected deposit withdrawals for one day if retail depositors lose confidence in the banks.

need to shore up the core deposit base and keep an adequate cushion of liquid assets to meet unforeseen exigencies.

### 3.2.24 Stress Testing – An update

The above stress tests for credit, market and liquidity risk have been conducted as at end-March 2008. However, looking to the recent global financial developments and their likely impact on the Indian economy, the stress testing exercise was also carried out, wherever possible, as at end-September 2008.

*Credit Risk*

The updated stress tests on credit portfolio has been performed for the same scenarios as done for March 2008. The findings indicated that the impact of credit risk on banks' capital position continues to be relatively muted. Under the worst-case scenario (Scenario I), the overall capital adequacy of the banking sector declined to 10.6 per cent (11.0 per cent as at end-March 2008). Number of affected banks remained stationary at 12 between March and September 2008. However, the 12 affected banks in September 2008 accounted for 13.6 percent of commercial bank assets as against 11.8 per cent in March 2008. (Table 3.13).

**Table 3.13: Stress Tests of Credit Risk - Scenarios and Results with Reference to September 30, 2008**

| | Without stress | Scenario I - Increase in NPAs | | | | | | | | Scenario II | | Scenario III | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 25% | | 50% | | 100% | | 150% | | | | | |
| | | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* | CRAR | Banks* |
| All banks | 12.5 | 11.8 | 4 | 11.6 | 4 | 11.1 | 8 | 10.6 | 12 | 11.2 | 12 | 12.0 | 2 |
| Nationalised | 12.0 | 11.2 | 2 | 11.0 | 2 | 10.5 | 4 | 9.9 | 6 | 10.2 | 5 | 11.5 | 1 |
| SBI Group | 12.1 | 11.1 | 0 | 10.8 | 0 | 10.3 | 0 | 9.7 | 2 | 10.6 | 2 | 11.4 | 0 |
| New Private | 13.9 | 13.5 | 0 | 13.3 | 0 | 12.8 | 1 | 12.4 | 1 | 13.4 | 1 | 13.7 | 0 |
| Old Private | 14.1 | 13.3 | 1 | 13.0 | 1 | 12.4 | 2 | 11.8 | 2 | 12.4 | 2 | 13.6 | 1 |
| Foreign | 12.2 | 12.0 | 1 | 11.9 | 1 | 11.8 | 1 | 11.6 | 1 | 11.5 | 2 | 12.1 | 0 |

* : Number of banks whose CRAR would fall below 9 per cent due to the shock.
**Source:** RBI (Supervisory Data).

Under Scenario I, the stressed CRAR at various levels of shocks for the entire banking system was registered as 11.8 per cent, 11.6 per cent, 11.1 per cent and 10.6 per cent (as against 12.3 per cent, 12.1 per cent, 11.6 per cent and 11.0 per cent as at end-March 2008), respectively. When NPAs were subjected to 150 percent increase in place of 25 percent increase, the number of affected banks rose to 12 from 4 (as against the increase to 12 from 5 as at end-March 2008).

Further, under Scenario II, system-level CRAR would decline to 11.2 per cent (as against 11.6 per cent as at end-March 2008) and as many as 12 banks (as against 15 banks as at end-March 2008) accounting for about 11.9 per cent (14.7 per cent at end-March 2008) of commercial banking assets would not be able to meet the stipulated minimum. Scenario III reveals that the proportion of the assets of the affected banks to the total commercial banking assets stood around 3.1 per cent (as against 2.1 per cent at end-March 2008).

The stress tests on credit portfolio indicated that the banking system remained resilient as at September 2008.

Banks are not at very significant risk from rise in interest rates or decline in equity prices.

The stress tests revealed that the banking system continued to remain resilient as at end-September 2008.

*Market Risk*

*Interest Rate Risk*

The DoE of the banks' portfolio, which was 8.0 years in March 2008, increased marginally to 8.1 years by September 2008. From the economic value perspective, the estimated erosion in capital funds (regulatory capital) due to a 100 bps increase in the interest rate would reduce the system CRAR from 12.5 per cent to 11.5 per cent in September 2008.

Given a DoE of 8.1 years, a 244 bps increase in yield as on September 2008 would result in nearly 20 per cent erosion in capital and reserves. From an economic value perspective, the system CRAR would reduce to 10.5 per cent. In such a scenario, the CRAR of 23 banks accounting for 20.5 per cent of the assets would be below the stipulated regulatory minimum of 9 per cent. When the same shock is applied to the banking book the system level CRAR reduces to 11.2 per cent, while the corresponding number for trading book 11.7 per cent. This shows that the banks are not at very significant risk from rise in interest rates.

*Equity Price Risk*

A stress test similar to the one conducted for end-March 2008 was conducted for end-September 2008, which revealed that CRAR would decline from 12.5 per cent to 11.7 per cent which is still well above the regulatory limits.

*Liquidity Risk*

Liquidity position of systemically important banks are generally comfortable.

The percentage of eligible investments reduced from 27.8 per cent of NDTL as at end-March 2008 to 26.1 per cent as at end-September 2008. This reduces the banks' ability to take recourse to the central bank liquidity window in times of liquidity shortage.

An analysis of the liquidity ratios revealed that banks' dependence on purchased liquidity continued to remain high in September 2008. Banks exhibited increased dependence on volatile liabilities as a funding source. Also, the embedded illiquidity in the banks' balance sheet increased (Table 3.14).

Like in the case of end-March 2008, a liquidity scenario analysis as at end-September 2008 was done in respect of the five largest banks in terms of asset size.

| Table 3.14: Liquidity Ratios | | |
|---|---|---|
| **Ratio** | **Mar-08** | **Sep-08** |
| (Volatile Liabilities –Temporary Assets)/ (Earning Assets –Temporary Assets) (per cent) | 43.9 | 49.3 |
| (Core Deposits)/Total Assets (per cent) | 49.3 | 47.7 |
| (Loans + Mandatory CRR + Mandatory SLR + Fixed Assets)/ Total Assets (per cent) | 86.3 | 86.5 |
| (Loans + Mandatory CRR + Mandatory SLR + Fixed Assets)/ Core Deposits | 1.8 | 1.8 |
| Temporary Assets/Total Assets (per cent) | 52.0 | 53.6 |
| Temporary Assets/Volatile Liabilities | 0.71 | 0.70 |
| Volatile Liabilities/Total Assets (per cent) | 73.1 | 76.5 |
| (Market value of Non-SLR Securities + Excess SLR Securities)/(Book Value of Non-SLR Securities and Excess SLR Securities) | 1.0 | 1.0 |

**Source :** RBI (Supervisory data).

Banks' dependence on purchased liquidity continued to remain high.

The findings indicated that, under the first scenario, total deposit withdrawal on Day 1 accounted for 5.8 per cent of total deposits of these banks. Two banks would exhaust their stock of liquid assets and end up with a marginal negative balance at the end of the second day. Another bank would exhaust its stock of liquid assets by the end of the third day.

Under the second scenario, 4.4 per cent of total deposits would be withdrawn on the first day and all the five banks would be able to meet their stressed repayment obligations on the first two days. Two banks exhibited liquidity strains from Day 3 onwards. Another bank would turn into deficit mode from Day 4 onwards.

In the third scenario, all the banks were found able to meet the devolvement of their contingent liabilities during the first month. One bank exhausted its stock of liquid assets by the end of three months, which deteriorated in a six-month horizon.

*Conclusion*

There does not seem to be very significant deterioration in the resilience of the banking sector between March and September 2008. The banking sector seems resilient to credit and market shocks in September 2008. However, the banks need to be more cognizant of the liquidity risk embedded in their balance sheet and pursue a policy of more effective liquidity risk management.

### 3.2.3 Assessment of Adherence to Basel Core Principles (BCPs)

Adherence to BCPs in regulation and supervision of commercial banks was assessed earlier as part of FSAP in 2001 and also as part of the self-assessment of standards and codes by the Standing Committee on International Financial Standards and Codes in 2002 and by a Review Committee in 2004. The earlier results are not strictly comparable to the present assessment inasmuch as the BCPs were revised in October 2006 and earlier assessments were based on BCPs devised in October 1999. The status of compliance to BCPs by commercial banks as assessed by the Advisory Panel on Financial Regulation and Supervision is summarised below (Table 3.15).

There does not seem to be very significant deterioration in the resilience of the banking sector between March and September 2008.

| S. No. | Principle | Status of Compliance |
|---|---|---|
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | C |
| 3. | Licensing criteria | C |
| 4. | Transfer of significant ownership | C |
| 5. | Major acquisitions | C |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | C |
| 7. | Risk management process | MNC |
| 8. | Credit risk | LC |
| 9. | Problem assets, provisions and reserves | LC |
| 10. | Large exposure limits | C |
| 11. | Exposure to related parties | MNC |
| 12. | Country and transfer risk | C |
| 13. | Market risk | MNC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | LC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | LC |
| 18. | Abuse of financial services | LC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | MNC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | LC |
| 25. | Home-host relationship | MNC |

**Table 3.15: Summary Assessment of Commercial Banks**

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant
**Source :** Advisory Panel on Financial Regulation and Supervision.

The assessment revealed gaps in risk management, supervisory approach and home-host relationship.

The assessment showed that the number of principles which are compliant are seven, largely compliant are 11, materially non-compliant are six and non-compliant is one. The materially non-compliant areas pertain to principles relating to risk management, exposure to related parties, market risk, liquidity risk, supervisory approach and home-host relationships, all of which require further strengthening. The non-compliant principle related to interest rate risk in the banking book as the Reserve Bank had not issued any guidelines to banks in this regard at the time of assessment. In this context, it is to be noted that the Reserve Bank has since issued guidelines on interest

rate risk in the banking book as part of the supervisory review process under Pillar II of Basel II, which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009[14].

The assessment also revealed that the responsibilities and objectives of the supervisory authority are clearly defined. A suitable legal framework is also in place. The Reserve Bank has arrangements in place for sharing information with domestic regulators. The licensing criteria and permissible activities that can be undertaken by a bank are clearly defined. There are also guidelines in place for fit-and-proper criteria in respect of directors and top management. The Reserve Bank has the power to review and reject any proposal to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. Detailed guidelines on capital adequacy covering both on- and off-balance sheet items have been issued to banks. The Reserve Bank has issued detailed guidelines on credit risk, market risk, country risk and operational risk. It has also issued detailed guidelines on Know Your Customer (KYC) and Anti-Money Laundering (AML) concerns. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. The CFSA notes that the banks are presently inspected on CAMELS and CALCS model as regards domestic and foreign banks, respectively. Further, some banks are also subjected to Risk Based Supervision (RBS) on pilot basis. However, it notes that the Reserve Bank has since constituted an internal group to review the existing RBS framework and suggest a new model with an aim to integrate CAMELS and SRP frameworks of Pillar II of Basel II with RBS.

The assessment revealed gaps in the risk management, exposure to related parties, supervisory approach and home-host relationship. The gap in supervisory approach is mainly due to the fact that the supervisor does have policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks but not for banking groups. With a view to achieve convergence to BCPs in areas where gaps have been observed, the Advisory Panel has made appropriate recommendations. These are given below.

### 3.2.31 Independence and accountability of the Reserve Bank and ownership issues of PSBs

*Independence of the Reserve Bank*

While the Reserve Bank enjoys independence *vis-à-vis* the executive arm of the State, the Central Government has powers to remove the Governor of the Reserve Bank without specifying any reasons and without publicly disclosing the reasons for removal of the head of supervisory authority. Considering the Reserve Bank's success as a regulator amidst its diverse activities and also that by convention the Reserve Bank's independence is

[14] Issues relating to this aspect are addressed in more detail in Chapter 3, Section.3.2.44.

fairly well established, at this stage there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/Deputy Governor could be removed. Such changes are not likely to add or make any material difference to the autonomy that the Reserve Bank already enjoys as a regulator. The CFSA is broadly in agreement with the Panel's views and further elaborates on it in the section on review of legislations.

*Accountability of the Reserve Bank*

The Reserve Bank has a statutory requirement of placing its Annual Report[15] and also the Report on Trend and Progress of Banking[16] before Parliament (through the Ministry of Finance). Though the Annual Report among other things covers aspects related to regulation and supervision of banks and the Report on Trend and Progress in Banking relates to the working of banks and financial institutions, the Panel was of the view that, though conventionally it is interpreted that the Reserve Bank is indirectly accountable to Parliament through the Ministry of Finance, there was need for a more transparent framework of understanding to make the Reserve Bank specifically accountable to the Government for its regulatory and supervisory functions. The CFSA notes that the Reserve Bank is subject to direct examination by Standing Committees of Parliament and is hence fully accountable to Parliament. The view of the CFSA therefore is that the current framework is adequate.

**3.2.32 Risk Management**

*Credit Risk*

The Panel has recommended that the guidelines on credit risk management should require the banks' credit risk management policies/ strategies to include counterparty credit risk arising through various financial instruments. The CFSA concurs with the recommendation.

There is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/ Deputy Governor could be removed.

*Liquidity Risk*

The guidelines on liquidity risk do not capture the effect of other risks on the banks' overall liquidity strategy. The enhancement of knowledge and quantitative skills in the banking industry is an essential prerequisite for analysing contagion risk. The Panel recognised the existence of diverse risk

[15] As per Section 53(2) of the Reserve Bank of India Act, 1934.
[16] As per Section 36(2) of the Banking Regulation Act, 1949.

management techniques across the banking sector, and recommended that the implementation of contagion risk management techniques could be undertaken in a phased manner. To begin with, it could be mandated for those banks that possess appropriate skill sets. Banks should initially concentrate on knowledge and quantitative skill enhancement and fix a reasonable timeframe, say two years, before undertaking such forward-looking analysis of contagion risk.

Further, the extant guidelines on liquidity risk issued by the Reserve Bank are confined to the rupee balance sheet of the banks. Hence, the Panel felt that the Reserve Bank should consider issuing guidelines on liquidity risk which also cover foreign exposures of the bank.

The CFSA feels that the Panel's recommendations could be considered by the Reserve Bank.

*Operational Risk*

Highlighting the importance of operational risk management, Mr. Rosengren, the peer reviewer for assessment of Basel Core Principles, observed that financial institutions are increasingly using complex financial instruments. Many of these instruments do not trade through exchanges but through broker/dealer networks. In many such dealer markets, the role of operational risk in impeding the smooth functioning of markets has become a prominent problem and this issue needs to be examined.

Though various aspects relating to operational risk are covered sufficiently in the annual financial inspection reports for commercial banks, there is no reporting mechanism in place whereby the supervisor is kept informed of developments affecting operational risk in banks on an ongoing basis. The Panel recommended that the Reserve Bank should put in place a mechanism whereby banks are required to report developments affecting operational risk to the supervisor. The CFSA feels that the Panel's recommendations may be considered.

*Risk Management*

While interest rate risk guidelines have been issued, they do not specifically mandate the use of internal models for risk management, and there is no system of periodic validation and independent testing of models and systems in the banks. A rigorous model-building exercise is needed which will enable banks to adopt a more advanced Internal Rating Based (IRB) approach to credit risk and an Advanced Measurement Approach (AMA) for operational risk[17]. If a bank intends to take recourse to the IRB or AMA approach for assessing credit and operational risks respectively, it should have appropriate forward-looking models in place which should be validated periodically. It is recognised that the need for capacity building for banks and the Reserve Bank is a prime precondition in this regard. The CFSA endorses the Panel recommendation.

[17] As part of the way forward, the Reserve Bank has begun the preliminary work for implementation of advanced approaches for credit risk and operational risk.

Only those who meet the Reserve Bank's guidelines on 'fit and proper' persons both in letter and spirit should be appointed to the boards of banks.

*Provisioning Requirements*

The Reserve Bank has issued detailed guidelines on income recognition and asset provisioning. As per extant guidelines, provisioning is not done on an individual basis for the sub-standard category of NPAs. Keeping in view the cost of compliance, the present stipulations could continue for the present. Considering the very large number of low-value NPAs which are sub-standard, if at all provisioning has to be done individual account-wise, a cut-off level should be set above which all accounts can be provided for individually. This cut-off level may be lowered in a phased manner. The CFSA endorses the Panel's view.

**3.2.33 Internal control**

*Fit-and-proper criteria for Board members*

The Reserve Bank issued guidelines in 2004 regarding fit-and-proper criteria for directors of private sector banks. Likewise, guidelines were issued for fit-and-proper criteria for elected directors of nationalised banks in 2006 and the State Bank of India (SBI) and its associates in 2007. These guidelines require banks to undertake the test at the time of their appointment and renewal to the Board. The CFSA strongly believes that improved governance in banks requires the implementation of these guidelines in both letter and spirit. Further, banks are required to give a yearly undertaking on March 31 that the information already provided by them has not undergone any change and, where there is any change, requisite details are to be furnished by the directors forthwith. However, there is no requirement for the banks to notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management. The Panel recommended that the Reserve Bank may issue specific guidelines that mandate banks to notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management. The CFSA endorses the view of the Panel.

A commercial bank must notify the Reserve Bank immediately of any negative reports about Board members/senior management.

*Segregation of Duties and Responsibilities in Treasury Operations*

Though the Reserve Bank has issued guidelines from time to time on the segregation of duties and responsibilities in the front office, middle office and back office for treasury operations, it is not being determined whether there is an appropriate balance of skills and resources in the back office and control functions relative to the front office. The Panel recommended that the

Reserve Bank may issue appropriate guidelines to banks stressing the maintenance of such a balance by banks. The on-site inspection manual should incorporate a suitable provision mandating on-site inspectors to specifically comment on this aspect in their reports. The CFSA endorses the view of the Panel.

**3.2.34 Prompt Corrective Action**

The Basel Core Principles require that laws or regulations guard against the supervisor unduly delaying appropriate corrective actions. The concept of a Prompt Corrective Action (PCA) framework has been introduced by the Reserve Bank. However, there is no specified timetable for initiating mandatory actions and discretionary actions. The guidelines on the PCA framework should provide an appropriate timeline for initiating mandatory and discretionary actions to follow the identified triggers. If necessary, this could be finalised in consultation with the Government. This is an important issue on which the CFSA has a different perception. The matter is discussed in greater detail in Section 3.2.45.

**3.2.35 Consolidated Supervision and Cross-Border Activities**

*Consolidated Supervision*

Though the Reserve Bank has the power to define the range of activities of a consolidated group, it does not have the power to cause inspections of any entity within the banking group which is not under the regulatory purview of the Reserve Bank. It is recognised that the insertion of Section 29(A) (Power in respect of associated enterprise) in the Banking Regulation (Amendment) Bill, 2005 would empower the Reserve Bank to conduct consolidated supervision. The passage of the Amendment Bill in Parliament would resolve the issue.

*Cross-Border Activities*

The RBI Act does not explicitly provide for the Reserve Bank to enter into any agreement with corresponding home/host supervisors. Consequently, there is no formal Memorandum of Understanding (MoU), and there is no agreed communication strategy between home/host regulators. There should be specific provisions in the RBI Act, 1934 and Banking Regulation Act, 1949 along the lines of the SEBI Act, 1992 so that MoUs can be entered into with foreign supervisors to establish formal communication mechanisms. However, specifically empowering foreign entities to inspect domestic banks through amendment of the Act may not be feasible. There can perhaps be a clause in the MoU enabling foreign regulators to inspect branches of foreign banks in India, subject to specific approval by the Reserve Bank and reciprocity. The CFSA notes that an inter-departmental group has been constituted to review the existing regulatory and supervisory framework for overseas operations of Indian banks and recommend appropriate changes including off-site reporting systems.

The CFSA notes that the ongoing global financial crisis has highlighted the importance of cross-border co-operation. It also notes that the G-20 has in

its recent meeting also highlighted the importance of cross-border co-operation and the need for regulators and other relevant authorities as a matter of priority to strengthen co-operation on crisis prevention, management and resolution. However, till the time a global agreement is reached in this regard, the CFSA feels that the pros and cons of an arrangement as proposed by the Panel needs to be viewed before taking a firm decision on the matter.

**3.2.4 Issues and concerns**

In addition to the gaps identified in the course of assessing the Basel Core Principles, certain broad issues relating to commercial banks were commented upon by various Advisory Panels. The major issues which were identified by the Panels are discussed in detail below.

**3.2.41 Ownership issues in Commercial Banking**

International experience shows that ownership structure is an important issue in banking as it has a strong bearing on financial stability, performance and financial sector development. The CFSA strongly believes that this issue should not be viewed from an ideological stance, but any discussion should be rooted in country-specific circumstances.

Commercial banking, which was privately owned until the beginning of the 1950s, remained predominantly private even after the State Bank group became part of the public sector in the mid-1950s. This status continued until major banks were nationalised in 1969 and 1980. Foreign banks were always present with their niche business and new private sector banks made an entry after reforms in the 1990s. Thus, overall, while the commercial banking business remains fairly diversified, the sector is currently dominated by public sector banks (PSBs) which accounted for around 70 per cent of the banking assets in March 2008, although since the inception of financial sector reforms, their share has come down significantly from a peak of 90 per cent in 1991. Growing pressure from enhanced competition has also led to a significant increase in the share of new private banks whose asset base increased from 6 per cent in 2001 to 17 per cent in 2008. The Herfindahl Concentration Index shows that the Indian banking system is 'loosely concentrated'. The concentration in the Indian banking sector as measured by the Herfindahl Hirschman ratio is significantly lower than in other emerging market economies and is comparable with advanced economies[18].

Global agreement is required to be reached on the issues of cross-border co-operation before entering into formal MoUs with foreign regulators.

[18] Ref : Section 3.2.12 ibid.

*Issues pertaining to Government Ownership*

The banking sector is predominantly government-owned with PSBs accounting for more than 70 per cent of the assets. PSBs are governed by their own statutes besides the Banking Regulation Act, 1949. The initial capital infusion in order to meet increased capital requirements subsequent to the introduction of Basel norms was brought about through the Government recapitalising these banks. Subsequently, public sector banks were allowed to raise funds from the market through equity issuance, subject to the maintenance of 51 per cent public ownership. As a result, ownership in public sector banks is now well-diversified. Since Government ownership in public sector banks could be divested only by accessing the stock markets, 22 out of the 28 public sector banks accounting for more than 90 per cent of the total assets of PSBs are listed in the stock exchanges, with government ownership varying from 51 per cent to 80 per cent. Mr. Andrew Sheng observed that as long as state plus public pension funds own more than 51 per cent, the state could own directly less than 51 per cent and these funds could be treated as state. This would lead to a more market-oriented PSB environment with the state being seen as broadly in control. The Panel on Financial Stability Assessment and Stress Testing did not accept this suggestion since, if pension funds were to be counted as part of the state, there would be legal issues as banks would no longer be counted as Government companies and, therefore, would lose their 'public' status.

PSBs are competing relatively effectively with private sector and foreign banks.

In this context, the relevance of privatisation of PSBs, on the grounds of promoting competition and strengthening financial performance, coupled with further liberalisation measures like freedom for foreign investment and entry of foreign banks in the banking sector needs to be deliberated upon in detail. The issue needs to be viewed from the perspective of efficiency because the ultimate goal of any such exercise should be to make the commercial banking system efficient in mobilisation of savings and as purveyors of credit. The CFSA would like to take a nuanced and more pragmatic view on this issue on several considerations.

Contrary to the general perception that PSBs are monoliths, the 28 PSBs compete not only with each other but also with private and foreign banks. The pros and cons of having PSBs should be clearly appreciated (Box 3.2). [One member, however, was of the opinion that 70 per cent of the assets of commercial banks being held by the public sector banks, where Government is the majority shareholder, could affect competition.]

Ownership in public sector banks is now well-diversified.

In recent years overall efficiency in the functioning of the banking sector has improved. PSBs appear to have responded to the new challenges of competition, as reflected in their increased share in the overall profit of the banking sector. This suggests that with operational flexibility, PSBs are competing relatively effectively with private sector and foreign banks. Since the banking sector reforms in the mid-1990s, PSBs have improved their

**Box 3.2: The Pros and Cons of Public Sector Banks in India**

**Pros**

- Given their public sector nature, it augurs well for financial stability as these institutions enjoy implicit government guarantee.
- The economy has been able to realise certain social objectives through these institutions by enforcing provisions related to spreading the reach of banking in the country through these institutions.
- PSBs have been active agents in promoting financial inclusion.
- Given the spread of these institutions, they have been able to tap and mobilise retail deposits.
- Given their spread, they have been able to fund the requirements of small and marginal farmers as also other SMEs.

**Cons**

- The functioning of PSBs is often subject to inflexible and, at times, dated rules. The layered decision-making process and uniformity in rules across the banks could impinge on their flexibility in operations. The stringent CVC guidelines, which the PSBs are subjected to, make it difficult for them to innovate and compete with the private sector and foreign banks who enjoy relatively greater flexibility in operations.
- HR issues, such as development of core competence, appropriate and market-related incentive structure, and attractive career paths make it difficult for PSBs to attract and retain talent. The productivity of human capital, which is measured in terms of business per employee, is observed to be lower in PSBs than in private and foreign banks, though this could be attributed to the larger spread of PSBs.
- Politically-influenced process of appointing board members.
- Bureaucratic system of appointing chief executives.

financial performance and there has been an overall convergence in the financial results of PSBs with the other banking groups (Table 3.16).

PSBs have improved their financial performance and there has been an overall convergence in the financial results of PSBs with the other banking groups

Other issues that may be relevant are stability considerations and the need to expand the banking business in consonance with economic growth that had picked up momentum. While the number of deposit-taking institutions[19] per million people in India is high, the banking assets to GDP ratio is still low compared to many emerging market economies which have higher incomes per capita. The bank deposits to GDP ratio (deflated by Consumer Price Index) in India has shown some improvement in recent years. It is, however, still lower than some Emerging Market Economies

[19] Deposit-Taking Institutions include scheduled commercial banks, regional rural banks, urban co-operative banks, rural co-operative institutions and deposit-taking non-banking companies.

| Table 3.16: Financial Indicators of Banks | | | | | |
|---|---|---|---|---|---|
| | | PSBs | OPBs | NPBs | FBs |
| **CRAR** | 1997 | 10.09 | 11.70 | 15.33 | 10.42 |
| | 2008 | 12.51 | 14.08 | 14.39 | 13.08 |
| **Gross NPA ratio** | 1997 | 17.84 | 10.71 | 2.63 | 4.29 |
| | 2008 | 2.23 | 2.25 | 2.90 | 1.75 |
| **Net NPA ratio** | 1997 | 9.18 | 5.48 | 2.49 | 2.37 |
| | 2008 | 0.99 | 0.66 | 1.21 | 1.21 |
| **RoA** | 1997 | 0.57 | 0.91 | 1.84 | 1.19 |
| | 2008 | 0.82 | 1.02 | 0.98 | 1.80 |
| **RoE** | 1997 | 9.37 | 15.51 | 19.50 | 10.73 |
| | 2008 | 13.72 | 12.90 | 8.90 | 13.50 |
| **Cost-income ratio** | 1997 | 64.31 | 56.20 | 38.34 | 45.54 |
| | 2008 | 48.87 | 47.38 | 53.95 | 42.95 |

Figures in per cent
PSBs-Public Sector Banks
OPBs-Old Private Sector Banks
NPBs-New Private Sector Banks
FBs-Foreign Banks
**Source**: RBI (Supervisory Data)

(EMEs) in Asia. It was 0.53 in the case of India in 2006[20] as against 1.16 in Malaysia, 0.94 in Thailand and 0.87 in Israel; however, these countries have significantly higher per capita incomes. Further, an analysis of 116 countries covering both developed and developing countries on bank deposit growth and per capita GDP in 2006 reveals that India is much above the trend line in this regard. In other words, the rate of growth of bank deposits in India, was higher than in countries with similar per capita incomes[21]. The CFSA observes that the predominance of PSBs, by virtue of implicit government guarantee, promotes financial stability. These banks also play an important role in augmenting financial inclusion as part of equitable development of the sector. According to the Financial Development Index, 2008 (World Economic Forum) the Indian banking system has been considered to be very stable.

On ownership, two particular issues have been raised by the Panels. The Panel on Financial Regulation and Supervision has raised the issue of conflict of interest, arising from the Government being the owner of both the regulator, which is the Reserve Bank, and the regulated entities. Undue Government influence can hinder sound and effective governance, effective regulation and economic development. Eric Rosengren, President and CEO, Federal Reserve Bank of Boston, who peer reviewed the Panel report also felt that the report could elaborate on aspects relating to the Central Government's role in the operation of public sector banks and how the involvement of the Government affects the ability of the Reserve Bank in carrying out its regulatory and supervisory duties. Taking on board the peer reviewer's comments, the Panel recommended that the Government should give up its role as a majority shareholder in the PSBs.

The predominance of PSBs, by virtue of implicit government guarantee, promotes financial stability.

[20 & 21] Source: Report on Currency and Finance 2006-08.

The CFSA, however, feels that there is no conflict of interest in Government's role as owner of banks and its relationship with the regulator. The Reserve Bank is an independent regulator and neither its powers to regulate PSBs decrease nor is any regulatory forbearance exhibited by it towards these banks because of government ownership. The same set of regulations are applicable to all banks, irrespective of their ownership, across the board. All banks are subject to annual financial inspections and the findings of the inspection are placed before the Board for Financial Supervision. However, there are some government sponsored schemes implemented by PSBs for which the amount of subvention[22], if any, is borne by the Government. The Government as the owner of the PSBs conducts quarterly review of the performance of PSBs against the statement of intent submitted by these banks.

Mr. Sundararajan, also felt that though government ownership augurs well for systemic stability, there are adverse consequences inasmuch as it causes regulatory forbearance that might lead to larger fiscal costs over the medium term. These concerns impact on supervisory independence and a level playing field. The Panel on Financial Stability Assessment and Stress Testing pointed out that the cost of recapitalisation of PSBs has been relatively low compared with other countries, and that any suggestion that the Government must exit its monitoring function and leave governance entirely to a duly-constituted board is unrealistic in the present environment and such a move might be undesirable as well. A more appropriate route to enhance corporate governance would be improve the bank management's flexibility in decision making, unhindered by Government interference. At the same time, if PSBs have to grow and compete with other players in the banking system, they need to augment their capital base. Given the fact that many PSBs (in the present context nationalised banks) are touching the borderline 51 per cent of shareholding by the Government and the impending need to implement Basel II which could require more capital, it is even more necessary for these banks to explore the possibility of raising additional capital without burdening the fiscal balances.

Any suggestion that the Government must exit its monitoring function and leave governance entirely to a duly-constituted board is unrealistic in the present environment and such a move might be undesirable as well.

The Panel had assessed that for the nationalised bank group, by 2012-13 the additional capital contribution from the Government would be Rs.2,134 crore, Rs.16,321 crore and Rs.49,552 crore for an expected annual growth in risk weighted assets of 20 per cent, 25 per cent and 30 per cent respectively. Assuming a 12 per cent increase in nominal GDP for the period 2007-08 to

[22] For *e.g.*, 3 per cent interest subvention scheme for short-term crop loans in 2008-09.

2012-13, the required cumulative capital infusion would amount to 0.6 per cent of the GDP at 2012-13 if the annual growth rate in RWA is about 30 per cent. Given the need for capital augmentation and the current policy scenario, the Panel recommended that selective relaxation can be granted to banks that have government ownership on the borderline of 51 per cent and the extent of dilution could be decided on a case-by-case basis. This could be effected through the Government providing matching capital to these banks or by making legislative amendments. Several other possibilities, like issuance of perpetual preference shares without voting rights and perpetual preference shares in foreign currency, golden shares, *etc.*, could be considered. On shortage of capital, Mr. Andrew Sheng feels that introducing different forms of tier II capital will only give the illusion of capital but are in reality another form of debt. Hence, the emphasis should be on strengthening banks' core capital and on raising this through the capital market. The Government could relax its 51 per cent limit if given a golden share or by including pension fund holdings within the 51 per cent limit.

CFSA notes that two nationalised banks still have 100 per cent government ownership and as many as eight PSBs have government holdings of more than 60 per cent, thereby leaving ample room for further dilution of equity within the legislative requirement of government holding being retained at 51 per cent in respect of these banks. Banks still have sufficient room for raising innovative capital as part of tier I and head room in tier II. However, going forward this may not be adequate as shown in a projection of capital requirements made by the Advisory Panel on Financial Stability Assessment and Stress Testing. The projection shows that there would be a requirement of Rs.49,552 crore of government investment in nationalised banks' (other than State Bank group) capital by 2012-13 if the risk-weighted assets are assumed to grow at a rate of 30 per cent per annum[23]. If the rate of growth of RWA is, however, assumed to be lower at 25 per cent, the capital requirement would be around Rs.16,300 crore which is manageable within the resources of the Government.

The CFSA endorses the view that as the economy is expected to grow at 8 to 9 per cent over the next decade, the PSBs would need additional capital, necessitating Government contribution if the shareholding of the Government is not to be reduced below 51 per cent. By investing around Rs.10,000 crore in the rights offer of the State Bank of India (SBI), the Government has demonstrated that the growth of public sector banks need not necessarily be constrained for want of adequate capital. The CFSA notes in this context that the Rs.10,000 crore that has been invested in SBI is through issue of special recapitalisation bonds and not cash. Such special bonds are not very liquid and, moreover, such a practice may not be favoured from a fiscal transparency angle.

[23] The Government feels that an expectation of 30 per cent growth in risk weighted assets is on the higher side.

In this context, the Government and the Reserve Bank can consider the following steps as a way forward:

1. CFSA feels that amalgamation of banks including PSBs should be done keeping in view the synergies, complementarities and the regional spread of the banks proposed to be amalgamated. For those PSBs which are on the borderline of minimum government share holding, one option could be that they are amalgamated with other PSBs where the government holding is considerably higher than the stipulated minimum of 51 per cent. This, however, should be done only if there are synergies to be exploited through such amalgamations[24]. The new entities would be in a position to expand their business, at least for some time. As these amalgamations will be between the PSBs, the concerns regarding possible disharmony in work conditions and work ethics of the merged entities that could give rise to HR and IR issues will be obviated significantly. Over time, this could lead to the emergence of a few large public sector banks, which could be better placed to exploit synergy and compete on the global stage.

2. Given that the Government has been the owner of PSBs, expecting that it would not give any directions may not be feasible. In practice, the CFSA observes that the Government generally does not issue formal directions to public sector banks and, in most cases, suasive methods are used which could, however, be made more transparent. The CFSA, therefore, supports the view that there is scope for improving the governance of PSBs at the board level.

3. In order to have more flexibility in the functioning of PSBs, the CFSA observes that there could be a need for an enabling environment for the Government to reduce its majority shareholding. The reduction in government ownership below 51 per cent would have the following main advantages:
   a. It would enable banks to augment their capital base in response to business expansion without undue fiscal implications.
   b. The incentive structure of these banks would not be limited by the Government pay structure and it would be easier for these entities to attract and retain talent.
   c. The implementation of Basel II would necessitate considerable investment in technology and capacity building. However, the

The Government does not issue formal directives to PSBs.

[24] For a detailed analysis on bank consolidation, see Section 3.2.46.

CFSA notes that managerial autonomy has been given to the banks in 2005 and banks are free to decide on issues like technology upgrading and lateral recruitment of specialists. Increased private shareholding of PSBs would facilitate both technology upgrading and lateral recruitment of experts with appropriate skill sets in larger numbers.

The CFSA notes that these measures would require legislative changes. Once an enabling legal provision is available, selective relaxation could be granted to PSBs that have government shareholding at the borderline of 51 per cent and the extent of dilution can be decided on a case-by-case basis. It may be noted that among the more successful new private sector banks are those emerging from or promoted by erstwhile public sector or quasi-public sector financial institutions. Once the process of dilution of government shareholding below 51 per cent in select public sector banks is begun, such banks would be able to operate in ways similar to the new private sector banks. Such a process would be effective in introducing increased competition and, hence, increased efficiency in the Indian banking system. However, dilution of government shareholding should be subject to certain conditions:

(i) The private shareholding of entities arising out of converted PSBs should be widely held. The Government may still be a significant shareholder.

(ii) To help attract quality professionals in the Board, the CFSA agrees with the Panel recommendation that the guidelines regarding substantial interest[25] need to be reviewed and the limits defining 'substantial interest' revised upwards (Section 3.2.42).

(iii) These entities would be entrusted with the same responsibilities and would continue to undertake government agency functions for which appropriate and adequate compensation will be paid.

*Old Private Sector Banks*

The Panel on Financial Stability Assessment and Stress Testing clearly brings to the fore the vulnerability of the smaller old private sector banks[26]. While these banks do not breach any regulatory limits, their efficiency indicators are significantly less healthy than the system average. Though these banks may not be of systemic concern, their comparatively weaker

Among the more successful new private sector banks are those emerging from or promoted by erstwhile public sector or quasi-public sector financial institutions.

[25] Section 10 A (2) of the Banking Regulation Act, 1949 requires that not less than 51 per cent of the Board of the bank shall have special knowledge or practical experience in areas of accountancy, banking, finance, economics, *etc.* Further, directors specified under Section 10A(2) should not have substantial interest in a company or a firm. As per Section 5(ne) of the Banking Regulation Act, 1949, substantial interest means an amount paid up exceeding Rs.5 lakh or ten per cent of the paid-up capital of the company, whichever is less. In effect, it would not be possible for any person holding more than Rs.5 lakh worth of paid-up capital in any company to become a member of banks' boards.

[26] 'Smaller old private banks' for the purpose of the analysis has been defined as those banks with an asset base less than Rs.6,000 crore.

The performance of old private sector banking group has improved as a result of mergers/ amalgamations.

financial performance coupled with corporate governance issues make these entities fit cases to be merged with larger and financially stronger public or private sector banks. The CFSA notes that there has been improvement in the performance of old private sector banks consequent to merger/amalgamation of some of these weaker banks and, hence, the performance of the remaining old private sector banks is almost close to the system average. Hence, it reiterates that the Reserve Bank may consider creating a conducive environment for mergers/amalgamations to enable market-driven amalgamation of these entities.

*Foreign Ownership of Indian Banks*

While discussing the roadmap for the presence of foreign banks in India, the Panel on Financial Stability Assessment and Stress Testing underscored the need to recognise that Indian operations of large global banks could form only a small portion of their global business and strategic decisions of the parent banks may have serious effects in Indian markets. The Panel endorsed the Reserve Bank's approach on the roadmap for foreign banks where a review is due after March 2009, concerning extension of national treatment to Wholly-Owned Subsidiaries (WoS), dilution of stake and permitting mergers/ acquisitions of any private sector bank in India with foreign banks.

The CFSA notes that there is a widely-held perception that entry of foreign banks could enhance overall efficiency of the banking sector through adoption of new technologies, products and management techniques brought about by these entities. These entities would also have greater access to diversified sources of funding and could foster innovation, efficiency and development of financial markets by widening the variety of financial products and their sophistication. The CFSA, however, notes in this regard that the new private sector banks currently operating in India have also adopted new technologies, offer varied products and have good management techniques in place which are comparable with the foreign banks. The induction of new technology may not be a major issue in India where IT services are growing at a fast pace.

India has been fairly liberal in according branch licences to foreign banks

The Reserve Bank's regulatory approach towards foreign banks has generally been liberal compared to global standards, which is characterised by a single class of banking licence, no restrictions in setting up non-banking financial subsidiaries in specified activities, uniform deposit insurance, uniform prudential norms and lower priority sector requirements. India has also been fairly liberal in according branch licences to foreign banks which is

generally more than 12 a year as per its commitment to the World Trade Organisation (WTO).

Although efficiency gains from the increased presence of foreign banks need continued consideration, there would be a need to consider other kinds of impacts that the operations of foreign banks may have. The CFSA, therefore, feels that the entry of foreign banks needs to be gradual and consistent with the overall financial policy strategy and the transition should happen smoothly without causing serious imbalances. A detailed cost-benefit analysis of the impact of the entry of foreign banks in the Indian financial sector could be useful before any concrete decision is taken on the matter. Accordingly, the CFSA feels that the government and the Reserve Bank could consider the following issues while reviewing the roadmap of foreign banks in 2009.

(i) Foreign banks can operate in the country either through branches or the subsidiary route. This could be subject to reciprocity.

(ii) The branch licensing policy of these entities could broadly be structured on the lines of that followed in case of new private sector banks, but consistent with the country's WTO commitments. Further, licensing of branches would continue to be based on reciprocity.

(iii) In the case of foreign banks adopting the subsidiary route, the foreign shareholding should not exceed 74 per cent. All regulatory guidelines and norms applicable to private sector banks could also be made applicable to them.

(iv) These banks should be listed on the stock exchange as this would enhance market discipline inasmuch as they would be subject to disclosure norms.

(v) There could be a need to have independent board members for subsidiaries of foreign banks to protect the interests of all stakeholders.

(vi) The expansion in operations of foreign banks should not affect the credit flow to agriculture and small and medium enterprises (SMEs). These issues need to be carefully weighed. In this context, there could be a need to strengthen accounting and disclosure rules for such sectors. If there is a policy-mandated requirement of funding such entities, there should be no discrimination between foreign and domestic banks.

(vii) Subsidiaries of foreign banks would be subject to all requirements that Indian banks are subject to.

Entry of foreign banks needs to be gradual and consistent with the overall financial policy

*Related issues of voting rights and controlling interest*

In terms of the statutory provisions under the various banking Acts, certain restrictions on voting rights have been stipulated:

(i) In the case of the State Bank of India (SBI), no shareholder, other than the Central Government, shall be entitled to exercise voting rights in excess of 10 per cent of the issued capital.

(ii) In the case of SBI Associates, no shareholder, other than the SBI, shall be entitled to exercise voting rights in excess of 10 per cent of the issued capital.

(iii) In the case of nationalised banks, no shareholder, other than the Central Government, shall be entitled to exercise voting rights in respect of any shares held by him in excess of 1 per cent of the total voting rights of all the shareholders of the bank.

(iv) In the case of private sector banks, no person holding shares, in respect of any share held by him, shall exercise voting rights in excess of 10 per cent of the total voting rights of all the shareholders.

One of the problems that prospective investors (both domestic and foreign) face in investing in a banking company is the aforesaid restrictions. Even if they have holdings of 49 per cent or 74 per cent, their voting rights are restricted to 10 per cent in the case of private sector banks and the SBI and its associates, and 1 per cent in the case of nationalised banks. The CFSA notes in this context that many jurisdictions do not allow individual ownership in banks of more than 10 per cent and further in most countries prior approval is needed if ownership is to exceed 10 per cent. In the Indian context there is already a proposal to remove the ceiling on voting rights in respect of private sector banks, which is awaiting the approval of Parliament. It also adds that if shareholding by a single individual investor or group of related entities exceeds the threshold 10 per cent, it would require prior approval from the Reserve Bank. While there is merit in allowing voting rights to be proportionate to shareholding, any shareholding in excess of the threshold 10 per cent should continue to need prior approval from the Reserve Bank. These are consistent with practices followed in advanced financial markets.

Any shareholding in excess of the threshold 10 per cent should continue to need the prior approval of the Reserve Bank.

**3.2.42 Governance Issues**

Section 10A (2) of the Banking Regulation Act, 1949 requires that not less than 51 per cent of the total number of members of the Board of Directors[27] of the banking company shall consist of persons with special knowledge or practical experience in respect of matters like accountancy, agriculture, banking, finance, economics, law, co-operation, small scale industry (SSI) or

[27] This is applicable to only 51 per cent directors having specialised qualifications.

any other matter the special knowledge of, and practical experience in, which would, in the opinion of the Reserve Bank, be useful to the banking company. Further, the members of the Board of Directors are not supposed to have substantial interest in, or be connected with – whether as employee, manager or managing agent – any company, not being a company registered under Section 25 of the Companies Act, 1956, or any firm, which carries on any trade, commerce or industry and which, in either case, is not a small-scale industrial concern, or be proprietors of any trading, commercial or industrial concern, not being a small-scale industrial concern.

The definition of 'substantial interest' in the Banking Regulation Act needs to be revised upwards.

As per Section 10A (2) (b) of the Banking Regulation Act, 1949, directors specified under Section 10A (2) should not have substantial interest in a company or a firm. As per Section 5(ne) of the Banking Regulation Act, 1949, substantial interest means an amount paid up exceeding Rs.5 lakh or 10 per cent of the paid-up capital[28] of the company, whichever is less. As a corollary, any such person having more than Rs.5 lakh of paid-up capital in any other company is ineligible to become a member of banks' boards[29]. It needs to be noted that this quantitative stipulation in terms of a specific nominal amount has proved to be very low because of inflation and also growth in size of banking companies. The CFSA, therefore, concurs with the Panel on Regulation and Supervision which recommends that the definition of 'substantial interest' in the Banking Regulation Act needs to be revised upwards to attract appropriate talent and professionalism in the banks' boards (Section 10 (A) (2) of the Banking Regulation Act, 1949). The CFSA feels that the quantitative ceiling of Rs.5 lakh could be removed and an appropriate per cent of paid-up capital can be stipulated. As regards listed banks, Clause 49 of the Listing Agreement prescribes that where the chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors. The CFSA feels that a stipulation similar in spirit could also be made applicable to unlisted banks.

The CFSA feels that, given the transformation that has taken place in banking, there is need for more professionals on the Board. Though the requirement of professional directors is applicable across the banking sector, and is not restricted to any particular type of bank, the CFSA concurs with the view of the Panel on Financial Stability Assessment and Stress Testing that the composition and professionalism of the Board of PSBs still remain a particular concern given its constraints regarding attracting appropriate talent. It has been pointed out by the Narasimham Committee (1988) and endorsed by the Panel on Financial Stability Assessment and Stress Testing that the predominance of government ownership has resulted in a blurring of the distinction between ownership, responsibility and managerial duties. The Panel on Financial Stability Assessment and Stress Testing recommended the following measures to enhance the corporate governance of PSBs:

Stipulation similar to Clause 49 of the listing agreement could be made applicable to unlisted banks.

[28] This is applicable to only 51 per cent directors having specialised qualifications.
[29] Substantial interest in SSIs is excluded.

(1) The Reserve Bank has issued fit-and-proper criteria for elected directors in nationalised banks and associate banks of the SBI. The Government has issued fit-and-proper criteria for all board members of PSBs. While this would include non-official government nominee directors, it is felt that appropriate care requires to be taken in ensuring proper quality of directors.

(ii) Improving flexibility in decision making, unhindered by Government interference.

While concurring with the Panel's recommendations, the CFSA notes that constructive intervention of the Government in critical areas such as agriculture and Small and Medium Enterprises (SMEs) may be necessary to fulfill the objectives of more inclusive growth.

The Reserve Bank, in the exercise of its delegated legislative powers under Section 35A of the BR Act, has issued directions to the banking companies to undertake a process of due diligence to determine the suitability of the person for appointment/continuing to hold an appointment as a director on their Board, based upon qualifications, expertise, track record, integrity and other fit-and-proper criteria. An amendment has been proposed in the Banking Regulation (Amendment) Bill, 2005 to ensure that ownership of banks is also with persons who have a fit and proper background.

While the scope of influence of CVC has changed over time, there is a case for considering redefining the scope of influence of external agencies like the Central Vigilance Commission (CVC) with regard to the banking business.

It has been observed that PSB officials are reluctant to take decisions for fear of violating Central Vigilance Commission (CVC) guidelines. The Government notes that scope of influence of external agencies like CVC over the years has undergone a change and have more or less moved with the times and the existing arrangement has worked well. However, CFSA felt that in case the Government remains the majority shareholder of commercial banks, there is a case for considering redefining the scope of influence of external agencies like the CVC with regard to the banking business. There may be a requirement to come out with a separate CVC manual in this regard. Finally the CFSA feels that corporate governance principles could essentially be the same across bank groups.

**3.2.43 Credit Growth**

The Panel on Financial Stability Assessment and Stress Testing observed that the Indian banking sector has witnessed a sharp pick up in credit from

2004-05 onwards. The past five years have seen the economy growing at 8 per cent plus (though some moderation in growth rates has been witnessed in 2008-09), generally benign inflationary conditions and rising income levels. Annual growth in bank credit, which averaged 14.9 per cent during 1991-98, accelerated to 25.8 per cent during 1998-2002 and further to 25.1 per cent during 2002-08. Though credit growth moderated somewhat in 2006-08, it continued to be high in absolute terms.

The period of increased credit off-take has also seen growth in sub-BPLR loans.

Credit growth has also been widespread with not much concentration risk. Though the flow of credit to the priority sector has been stable, there has been a decline in credit flow to the SSI sector. A disquieting trend has been the marginal increase in NPAs of retail assets which points to the need to exercise better credit discipline in loan administration. Given the cap prescribed by the Reserve Bank for capital market exposure, the exposure to capital market of banks has been low.

The Benchmark Prime Lending Rate (BPLR) should be the rate which is charged by the banks to the most credit-worthy customers. Banks are expected to take into account their (i) actual cost of funds, (ii) operating expenses, and (iii) a minimum margin to cover the regulatory requirement of provisioning/ capital charge and profit margin, while arriving at the BPLR. All other lending rates can be determined with reference to the BPLR arrived at, as above, by taking into account term premia and/or risk premia. It is, therefore, expected that ideally all bank loans should be disbursed at a rate either equal to or higher than the BPLR.

The experience in the Indian context, however, is different. The period of increased credit off-take has also seen growth in sub-BPLR loans; this is evident from the fact that such loans which comprised 27.7 per cent of total loans in March 2002 have shown an increasing trend during subsequent years and stood at 76.0 per cent as at end-March 2008 and further to 79.0 per cent at the end of June, 2008. This growth is highly noticeable in consumer credit, followed by term loans. The share of consumer credit in sub-BPLR loans which was 0.4 per cent in March 2002 stood at 15.2 per cent in March 2008. Despite the increase in sub-BPLR loans, there has been no deterioration in pricing or decline in interest margins of the banks. The BPLR should ideally be comprised of cost of funds, risk spread plus costs along with margin. Thus, if banks are able to lend at sub-BPLR and also maintain same interest margins, there are obviously issues relating to computation of BPLR.

There are issues relating to computation of BPLR which have implications for monetary policy transmission.

The CFSA notes that issues relating to sub-BPLR lending have implications for the monetary policy transmission channel inasmuch as the actual interest rates charged do not capture the expectation of monetary policy and are at times contrary to market expectations. Also, the credit market remains non-responsive to the interest signals emanating from the central bank. Another issue that needs to be taken into account is the implication of such lending on the risk profile of banks.

An area of concern was that the growth in credit significantly outpaced deposits in 2004-05 and 2005-06, resulting in an increase in the credit deposit ratio from 55.9 per cent at the end of March 2004 to 72.5 per cent as at end-March 2008. This increase was accompanied by a corresponding drop in the investment-deposit ratio which declined from 51.7 per cent to 36.2 per cent during the same period. The incremental credit deposit ratio increased from 56.5 per cent in 2003-04 to 72 per cent in 2007-08 peaking at above 100 per cent in 2004-05 and 2005-06. This period also saw an increase in dependence on bulk deposits to fund credit growth, which could have liquidity and profitability implications. An increase in growth in retail housing, real estate exposure as also the infrastructure sector as evidenced during this period have resulted in elongation of the maturity profile of banks. Simultaneously, there has been a shortening of residual maturity of liabilities leading to a higher Asset Liability Management (ALM) mismatch. The credit growth has been accompanied by a reshuffling of banks' asset portfolios by shifting from investments to advances, resulting in an increase in the embedded illiquidity in the banks' balance sheets. Post-March 2007 deposit growth significantly outpaced credit growth. This has implications for banks' ability to effectively deploy funds to assets. In the first half of 2008-09 there has been a significant growth in credit which is just marginally lower than the deposit growth. This growth has subsequently moderated in the third quarter of the current financial year. Between April 2008 and December 2008, the incremental credit deposit ratio stood at around 76 per cent.

Given the recent increase in the retail credit portfolio of banks, the financial health of the household sector becomes important. An assessment by the Advisory Panel on Financial Stability Assessment and Stress Testing of the available data revealed that the debt-asset ratio was generally higher for urban than for rural areas. In the case of urban and metro areas, a study by CRISIL revealed that for five years until March 2006, the affordability index[30] for home buyers was around 4.4. A stress test of twin shocks of an increase in property prices (by 50 per cent over March 2006) and an increase in interest rates on a 20-year loan to 10.5 per cent (from 8.75 per cent), taking into account the cushion of a 20 per cent increase in annual salary of the home buyer, indicated a rise in the affordability index to 5.5, which could mean elongation of maturity in the loan book of the banks and could be a cause for concern going forward.

[30] Affordability Index is defined as the ratio of property price to average net annual income; a higher value indicates lower affordability.

Given the high level of retail borrowings, primarily by urban households over the past several years, the Panel was of the opinion that a downturn in economic activity could rapidly impair their repayment schedule and engender increased indebtedness. Also, the lack of availability of relatively recent data on household indebtedness was a concern, particularly in view of the increase in the retail loan portfolio of banks in recent years and the possibility of a default on such loans given if there is an increasing interest rates as was observed till recently. The CFSA agrees with the concerns raised by the Panel.

Lack of recent data on household indebtedness remain a concern.

**3.2.44 Strengthening Risk Management in the Banking System**

Innovations in the form of complexity and sophistication of products and services, coupled with profitability and competitive considerations, have changed the dimensions of risks faced by banks. With the advent of very large banking groups that engage in a variety of business activities, it becomes necessary for such organisations to clearly understand the dimensions of risks and their potential impact. Merely managing risks individually in respect of each exposure does not suffice and it is important that they pay enough attention to aggregation of exposures across the entire organisation, *i.e.*, risks must be recognised and managed across the entire organisation. Rapid business growth also necessitates added attention to areas like management information systems, change-management controls, strategic planning, credit concentrations, and asset-liability management. The recent sub-prime turmoil has highlighted the importance of risk management and the need to strengthen it. Mr. Andrew Sheng, the peer reviewer for the Advisory Panel Report on Financial Stability Assessment and Stress Testing, has observed that risk management is linked to governance. Hence, change in governance is essential to help PSBs manage risks. As long as pay is constrained relative to private bank compensation, PSBs are unlikely to develop the kind of risk management capacity needed for global banks. They may lose valuable staff with superior skills to higher-paying private financial institutions. Globalisation of large Indian banks may come sooner than expected if capital account liberalisation is planned to be earlier. Governance changes may not be able to wait too long (Box 3.3).

Risks must be recognised and managed across the entire organisation.

*Integration of Risk Management*

The bottom line for today's banking institutions, particularly the larger and more complex ones, is that they must continue to monitor very carefully the embedded risks of their products and services, pay close attention to subtle changes in business practices that could affect the risks related to a given product, and fully understand how the risks in all their business lines intersect and combine to affect the risk profile of the consolidated entity. The CFSA endorses the view of the Panel on Financial Stability Assessment and Stress Testing that to handle this order of complexities, risk management functions need to be centralised and seamlessly integrated with business processes. The risk-return trade-off needs to be assessed for new business opportunities and incorporated into the designs of the new products. All risks

Risk management functions need to be centralised and seamlessly integrated with business processes.

### Box 3.3 Risk Management – Key Lessons and Recommendations

Risk management failures in major financial institutions were a major cause of the current crisis in the financial markets of developed countries and reflected shortcomings in both judgement and governance that were compounded by weaknesses in accounting and regulatory standards. Although risk management is principally the responsibility of senior management of financial institutions, supervisors have an important role in pressing for higher quality of risk management and governance in regulated firms and in encouraging more rigorous stress testing, which will require adequate supervisory resources and expertise. Experience has provided important lessons for both risk managers and supervisors pointing to the need for the following actions:

- Managers should challenge aggressively the assumptions underlying risk management and pricing models, especially for new and complex products, and adopt more rigorous stress testing for extreme or worst-case scenarios.
- Greater attention should be paid to the robustness of hedging strategies and understanding a firm's broader exposures, including the potential second-round effects of shocks on its main counterparties and other major market participants, and off-balance sheet obligations. Care will be needed to avoid equating credit ratings with liquidity, to limit concentrated positions in illiquid structured products, and to ensure that funding better reflects portfolio duration and liquidity.
- Supervisors should encourage more rigorous stress testing, especially in 'good times', use the results to inform their supervisory practices, and assess the quality of risk management and governance in regulated firms to ensure that senior management is well informed about the risks their firms are taking on.
- To perform these functions successfully, supervisors must have the required skills and resources. The experience of the previous year has exposed significant gaps in the ability of supervisors to understand the nature of banks' business and practices.

However, it is crucial to recognize that risk management cannot be achieved solely by regulation. The onus remains principally on senior management of financial institutions to ensure that internal governance structures are robust. Supervisors can play a role in supporting this process – a process that could be usefully supported with international dialogue and co-ordinated cross-border supervisory efforts. The Senior Supervisors Group is a welcome development in this regard.

This experience has also raised fundamental questions about the future of some structured credit products, such as ABS CDOs. These instruments are relatively opaque, illiquid, and complex, especially compared with other corporate credit securities and risk transfer instruments. Their design diminishes their signalling value, since it is difficult to gauge the quality and risk of their underlying credits. Securitization is an important and useful mechanism for pooling and transferring risk, but if ABS CDOs and similarly complex products are to continue to represent a significant part of the financial landscape, prudential or other measures may be needed to ensure that their implications for market discipline are effectively internalized.

**Source**: International Monetary Fund: The Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance.

– credit, market and operational – need to be combined, reported and managed on an integrated basis which, in addition to individual assessment and aggregation of each of the risks, takes into account the correlation and contagion effects of individual risks on aggregate risk facing the entity.

*RAROC Methodology*

The development of Risk Adjusted Return on Capital (RAROC) methodology began in the late 1970s, initiated by a group at Bankers Trust. Their original interest was to measure the risk of the bank's credit portfolio as well as the amount of equity capital necessary in order to limit the exposure of the bank's depositors and other debt holders to a specified probability of loss. Since then, a number of other large banks have developed RAROC or RAROC-like systems. The CFSA notes that, as stated by the Advisory Panel on Financial Stability Assessment and Stress Testing, the demand for RAROC-based performance measures will increase. RAROC will be used to drive pricing, performance measurement, portfolio management and capital management. Hence, it recommends that over a period of time the banks start adopting a RAROC-based approach. The CFSA notes in this regard that the adoption of RAROC would also require an estimation of economic capital.

*Internal Capital Adequacy Assessment Process*

The Basel Committee on Banking Supervision has brought out the New Capital Accord (known as Basel II) which has three pillars as part of its approach. The first pillar relates to minimum capital requirements, the second one is supervisory review and the third is market discipline. The CFSA notes that the Reserve Bank has issued guidelines on Basel II to commercial banks. This covers the internal capital adequacy assessment process as part of the supervisory review process under Pillar II of Basel II, which is currently applicable to banks with overseas operations and foreign banks, and will be extended to all other banks from March 31, 2009.

*Credit Risk Management*

Consequent to the issuance of various prudential guidelines relating to credit risk management and income recognition and asset classification norms, there has been substantial improvement in the asset quality of commercial banks. The net NPA ratio, which was around 8 per cent in 1997, declined to around 1 per cent by 2008. This decline was aided in no small measure by a series of legal reforms, notable among them being the initiatives of setting up Lok Adalats and Debt Recovery Tribunals. The promulgation of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and initiatives like one-time settlements have helped bring down NPA levels. The setting up of the Credit Information Bureau of India Ltd. (CIBIL)[31] in January 2001 (it started

[31] The Reserve Bank is in the process of finalising guidelines for establishing a state-of-the-art credit information system through registration and regulation of credit information companies.

functioning in 2004), the benign economic environment and the increase in transparency through the passing of the Credit Information Companies (Regulation) Act, 2005 have also played a major role in this regard. Against this background the stress test for credit risk undertaken by the Advisory Panel on Financial Stability Assessment and Stress Testing shows that in September 2008 there would be a decline in the CRAR of the banking system by 1.9 percentage point from 12.5 per cent to 10.6 per cent in the worst case scenario. This has been explained in detail under credit risk in respect of commercial banks (Section 3.2.21).

A recent working paper published by the IMF[32] notes that the recent crisis in developed countries' financial markets has *inter alia* highlighted issues relating to rapid credit growth. Credit growth has been more pronounced in the retail sectors, including housing and consumer loans, with the demand for corporate loans growing at a lower pace. Favourable macroeconomic conditions coupled with lower interest rates resulted in financial intermediaries ready to lend to riskier borrowers and lowering of credit standards in a 'search for yield'. The very rapid expansion of securitisation and the use of credit derivatives, such as credit default swaps, reflect this trend. This, in turn, led to banks inflating their customers' ability to repay loans. The crisis was aggravated, somewhat counter-intuitively, through the use of more sophisticated techniques in evaluating loans and collaterals, as also managing risks in general – all of which taken together might be termed 'loan technology'. Relationship banking yielded place to quasi-automated credit scoring systems. The supervisors also did not react to the situations through issuance of countercyclical prudential norms.

The Advisory Panel on Financial Stability Assessment and Stress Testing noted that the Reserve Bank has recognised the inherent risks in rapid credit growth, especially in the retail and housing loans segments, and cautioned banks on the need for proper risk assessments and honing of risk assessment skills. Risk weights for retail, retail estate and capital market exposures were enhanced as a countercyclical measure. Provisions for standard advances on exposures to these sectors were also increased, which would help to cushion any negative fallout of a cyclical downtrend. With the current moderation in economic growth and the need to provide impetus to certain sectors through a credit push saw some relaxation of these measures in November 2008.

[32] Daniel C. Hardy and Alexander F. Tieman (July 2008). Innovation in Banking and Excessive Loan Growth. IMF Working Paper.

Banks have also been advised to devise and improve their risk management systems tailored to their business philosophies. Besides, banks have built up comfortable capital buffers that can enable them to withstand exigencies in the real estate sector (see the stress tests on credit risk). Further, the Reserve Bank presently has stipulated limits on exposure to sensitive sectors and the level of consumer credit penetration is low compared to emerging economies.

The ills of excessive credit growth can be mitigated by prudential regulation and supervision.

These measures have yielded results inasmuch as the impact of the sub-prime turmoil on India has been relatively subdued. Given the Indian experience, the CFSA feels that the ills of excessive credit growth can be mitigated by prudential regulation and supervision. Specifically, detailed inspection of the quality of a bank's loan technology, combined with supervisory action to improve the quality if necessary, can play an important role. In addition, regulation encouraging increased transparency with respect to the quality of loan technology would reduce the incentive for using credit volume as a signal and, as such, would reduce over-extension of credit.

As noted by the Panel on Financial Stability Assessment and Stress Testing, a significant portion of other personal loans, *viz.*, credit card receivables and consumer durables, are uncollateralised. Also, the ratio of NPAs in the retail sector, though low in absolute terms, is showing a marginally increasing trend. It is not a matter of significant concern yet, but the CFSA concurs with the position taken by the Panel that there is a need to hone the credit assessment skills by banks in retail loan administration.

The Panel on Financial Stability Assessment and Stress Testing also noted that the development of a credit derivatives market could, to a great extent, be a risk mitigator as regards the credit portfolio of banks. At the same time, there is a need to tread cautiously in this respect as excessive dependence on the principle of 'originate to distribute' (OTD) could result in a compromise on loan evaluation and lead to an increase in systemic risk. The Panel observed that the credit derivatives market in India is in an embryonic stage and is yet to take off in a significant manner. The Panel observed that the Reserve Bank has kept in abeyance issue of guidelines on credit default swaps. However, it feels that there is a need to give an early fillip to the development of the credit derivatives market in India, once a degree of normalcy is restored in global financial markets, particularly taking into account the increasing credit portfolio in the banks' balance sheets and the need for greater flexibility in operations. It has recommended a series of measures in this regard.

Credit derivatives are an essential hedging tool for banks.

The CFSA acknowledges that credit derivatives are an essential hedging tool for banks as they facilitate diversification of risk, which improves the overall efficiency and resilience of financial markets. The CFSA also agrees with the Panel's observations that, given the capital constraints faced by the banking sector (public sector banks, in particular), there is a need to consider the introduction of a credit risk transfer mechanism, but this has to take into

There is a need to follow a gradualist approach by sequencing the reforms and putting in place appropriate safeguards before introducing credit derivatives.

account the state of development of financial markets and the availability of adequate depth among institutional investors. At the same time, changes in credit markets have also provoked some concerns and unease, particularly in view of the recent financial turmoil.

There is no denying that when accompanied by adequate risk management and incentives, the OTD model offers a number of benefits to loan originators, investors and borrowers. Originators can benefit from greater capital efficiency, enhanced funding availability, and lower earnings volatility since the OTD model disperses credit and interest rate risks to the capital markets. However, the recent turmoil has shown that, in some cases, risks that had been expected to be broadly dispersed turned out to have been concentrated in entities unable to bear them. Some assets went into conduits and Structured Investment Vehicles (SIVs) with substantial leverage and significant maturity and liquidity risk, making them vulnerable to a classic type of run. The banks ended up with significant direct and indirect exposure to many of these vehicles to which risk had apparently been transferred through contingent credit lines, reputational links, revenue risks and counterparty credit exposures. Thus, the recent crisis has highlighted the misaligned incentives along the securitisation chain, lack of transparency about the risks underlying securitised products, poor management of the risks associated with the securitisation business, such as market, liquidity, concentration and pipeline risks, including insufficient stress testing of these risks, and the usefulness and transparency of credit ratings.

Hence, the CFSA feels that there is a need to follow a gradualist approach by sequencing the reforms and putting in place additional safeguards before introducing credit derivatives. The pace of development of the credit derivatives and securitisation markets needs to be appropriately nuanced, with proper sequencing, and made subject to adequate prudential safeguards and proper accounting and disclosure norms. The CFSA feels that the Reserve Bank could consider the views of the Panel against this backdrop[33]. It also notes that the Reserve Bank is in the process of drafting final guidelines in respect of Credit Default Swaps. On the question of provisioning norms, the Panel recommended that banks migrate to dynamic provisioning as a pattern of general provisioning. The fundamental principle is that provisions are set against loans outstanding in each accounting time period, in line with an estimate of long-run expected loss. The CFSA recommends that the Reserve

The need for dynamic provisioning for a forward-looking system in managing credit risks needs to be looked in detail.

[33] For a more detailed exposition of CFSA's approach, see the section on credit derivatives. (Section 3.2.44)

Bank needs to look into this aspect in detail before introducing the concept of dynamic provisioning. Further, it concurs with the view of the Panel on Financial Regulation and Supervision that if at all provisioning has to be done account-wise in the case of substandard accounts, a pragmatic cut-off level should be set, above which all accounts can be provided individually. Mr. Andrew Sheng agrees with the need for dynamic provisioning and a forward-looking system in managing credit risks.

An assessment of Basel Core Principles in relation to credit risk showed that the guidelines on credit risk management do not require that the banks' credit risk management policies/strategies should also include counterparty credit risk arising through various financial instruments. The CFSA agrees with the recommendation of the Panel on Financial Regulation and Supervision that suitable guidelines addressing the gap may be issued.

*Liquidity Risk Management*

The recent sub-prime crisis has brought into sharp focus the importance of liquidity risk wherein some banks were holding illiquid assets in their portfolios; these could not provide the expected cushion when the market turned adverse, which was a clear case of market liquidity risk. Further, some of the entities could not roll over their liabilities at the time of maturity, thus getting exposed to funding liquidity risk. The crisis thus illustrated both the importance of funding liquidity risk and market liquidity risk which ultimately transformed into systemic risk when the risk posed by some entities affected the entire system, and the central bank of the country had to mediate by providing liquidity in the interests of safeguarding financial stability. Mr. Rosengren observed that the recent financial turmoil around the world has underscored the need for more careful management of liquidity risk.

The incidents of Northern Rock, Bear Stearns, Lehman Brothers, AIG, and Washington Mutual Fund, among others, have highlighted the fact that even large established financial institutions in well-developed financial markets can precipitate significant financial instability if liquidity risk is not addressed appropriately. In markets where aggregate volatility is greater, the importance of monitoring liquidity risk is likely to be greater as well.

The mechanisms for fulfilling the lender of last resort (LoLR) responsibilities have important implications for regulatory structure. In particular, the lender of last resort must have the ability and necessary data to assess the solvency risk and liquidity risk of institutions that use the facility. Apart from ensuring proper utilisation of the facility, this risk assessment capacity should also help reduce the incidence of events that cause an aggregate shortage of liquidity and thus call for interventions from the lender of last resort. The G-7 met on October 10, 2008 in Washington and agreed on a 5-point plan of action to restore confidence in financial markets.

Liquidity risk management needs to be accorded priority by commercial banks.

The Panel on Financial Stability Assessment and Stress Testing observed that the credit expansion witnessed by banks has been a function of exponential growth in the retail portfolio. The decline in the ratio of liquid assets to total assets is reflective of the increasing size of the loan book of banks. It highlights the importance of banks accessing low-cost and enduring deposit sources, and reducing the recourse to high-cost short-term borrowed funds to avoid potential asset-liability/maturity mismatches. Given the magnitude of the turmoil currently experienced in global financial markets, the Panel felt that liquidity risk management needs to be accorded priority by commercial banks. The CFSA concurs with the view of the Panel.

Contextually, the Panel carried out an analysis on liquidity risk from three angles: the traditional asset liability mismatch, analysis of select liquidity ratios and scenario analyses of liquidity. The analysis of the asset-liability profile of banks revealed that since March 2001 there has been a steady rise in the proportion of deposits maturing up to one year. At the same time, longer-term loans maturing after three years increased sharply during the same period. Funding of incremental asset growth by non-deposit sources has been the general trend, though in the past two years deposit growth has outpaced the growth in credit.

An analysis of liquidity ratios between March 2005 and September 2008 reveals that there is a gradual and growing dependence on purchased funds, coupled with an increase in the illiquid component of banks' balance sheets. There has been greater reliance on large liabilities to support asset growth. The dependence on volatile liabilities has also increased. Further, there has been a decline in the share of stable funding sources and greater reliance is being placed on short-term deposits and borrowings by the banks.

There has been a decline in the share of stable funding sources and greater reliance is being placed on short-term deposits and borrowings by the banks.

The liquidity stress scenario analysis carried out on the five largest banks based on their respective positions as at end-September 2008 revealed that under the worst-case scenario, which envisaged crystallisation of contingent credits/commitments as a result of changes in credit risk profile and delinquency in repayment of loans due to an economic downturn, as many as three banks would have exhausted their stock of liquid assets and ended up with a negative balance at the end of the third day. The CFSA notes that as the test was carried out in the case of the five largest banks, in the event of their facing strain, they could have had systemic implications and could put pressure on inter-bank markets. Thus, there is a need for the banks

themselves[34] as also the Reserve Bank to carry out such periodic stress testing in the case of some of the big banks, which have systemic linkages, and this could then be extended to other banks.

There is a need for banks as also the Reserve Bank to carry out periodic stress testing to assess systemic impact of liquidity stress on a few large banks.

In view of the results, the Panel underscored the need to strengthen liquidity management as excessive reliance on borrowed funds for funding asset growth could engender serious asset-liability mismatches in times of stress. The Panel stated that it may also be worth considering a specific regulatory capital charge if the bank's dependence on purchased liquidity exceeded a defined threshold. The Panel went on to recommend that the assessment of liquidity risk, which is part of the individual bank's internal capital adequacy assessments (ICAAP), should be supported by appropriate stress and scenario testing arising out of liquidity shocks.

In order to increase supervisory efficiency in this regard, Mr. Andrew Sheng felt that to avoid a repeat of the sub-prime crisis, individual institutions need to use more stress tests which should be supplemented by system-wide modelling of liquidity using different levels of margins and risk spreads. This would help the macroprudential supervisor understand where liquidity pressures may build up in the system as a whole rather than in specific institutions. The on-site examination process should be supplemented by a forensic 'follow the evolution of the product' approach which means following the evolution of a derivative product through its origination to the final holder to check whether the financial institutions, infrastructure and trading, clearing and settlement, and risk management processes along the trading chain are appropriate with sufficient due diligence and risk controls/ audit trail. The purpose of such a 'forensic' examination would be threefold: (a) to train examiners to understand complex products and 'follow the money'; (b) to alert market participants (including originators) that the regulators are alert and checking the controls at every level of the transaction, so that they would all be at risk of being tested; and (c) to reveal to the examiners how embedded leverage is increased and risks can transform (or be missed) at each stage of evolution of a derivative product. The view of Mr. Sheng has been endorsed by the Panel on Financial Stability Assessment and Stress Testing.

There is a need to consider a specific regulatory capital charge if banks dependence on purchased liquidity crosses a threshold.

Given the increase in off-balance sheet activities in bank's books consequent to the multifold increase in derivatives exposure over the years, the CFSA strongly recommends the early assimilation of this approach to the existing supervisory tools. While the CFSA notes that the Reserve Bank has issued guidelines on liquidity risk, these guidelines should be reviewed quickly to incorporate the above facts. It also endorses the stand taken by the Panel on Financial Regulation and Supervision that these guidelines should also cover foreign exposures of banks.

There is a need for early assimilation of a forensic 'follow the evolution of the product' in the existing supervisory tools.

[34] The Reserve Bank has issued guidelines on stress testing which include guidelines on liquidity risk.

Reserve Bank could consider the scope, application and implementation of the Principles for Sound Liquidity Risk Management and Supervision.

The CFSA endorses the stand taken by the Panel on Financial Regulation and Supervision that implementation of contagion risk management techniques, which would explicitly take into account the impact of other risks on liquidity risk, should also be undertaken in a phased manner. It also supports the stand taken by the Panel that banks should initially concentrate on knowledge and quantitative skill enhancement and fix a reasonable time-frame, say two years, before undertaking such forward-looking analysis of contagion risk. Therefore, to begin with this could be mandated only for the banks which possess appropriate skill sets.

The CFSA recognises the imminent need for capacity building in the context of effective management of liquidity risk. The CFSA holds the view that the Reserve Bank could examine this aspect in its totality, enabling it to take concerted action in a timely manner. It also notes that the Reserve Bank has initiated measures for bringing about improvement in ALM.

As a response to the recent financial turbulence, the Basel Committee on Banking Supervision (BCBS) has reviewed its Sound Practices for Managing Liquidity in Banking Organisations which was brought out in February, 2000, significantly expanding guidance in a number of key areas. It came up with the Principles for Sound Liquidity Risk Management and Supervision in September, 2008 (Box 3.4). Bank supervisors from various central banks and supervisory agencies have endorsed the principles in the International Conference of Banking Supervisors held on September 24 and 25, 2008 in Brussels. Though the liquidity position of Indian banks as assessed by the Panel has not revealed very alarming signs, some concerns have been expressed in particular relating to its growing dependence on purchased liquidity. The CFSA feels it would be expedient for the Reserve Bank to consider the scope, applicability and implementation of these principles for Indian banks.

Banks have been actively managing their interest rate risk by reducing their duration of equity.

*Market Risk*

The Panel on Financial Stability Assessment and Stress Testing observed that with the upturn in the interest rate cycle, banks have been actively managing their interest rate risk by reducing the duration of their assets. The DoE of the banks' portfolio, which was 14.1 years in March 2006, declined to 8.0 years by March 2008. From the economic value perspective, the estimated erosion in capital funds (regulatory capital) given the estimated yield volatility

## Box 3.4: Principles for Sound Liquidity Risk Management and Supervision

The Financial Stability Forum had in its report on Enhancing Market and Institutional Resilience in April 2008 stated that the Basel Committee on Banking Supervision (BCBS) will issue sound practice guidance on management and supervision of liquidity shortly. Accordingly BCBS has in September 2008 come out with guidelines underscoring the importance of a robust liquidity risk management framework that is well integrated into the bank-wide risk management process. It has emphasised among other things the following:

- Conduct regular stress tests for a variety of short-term and protracted institution-specific and market-wide stress scenarios and use the outcomes to develop robust and operational contingency funding plans;
- Ensure the alignment of risk-taking incentives of individual business lines with the liquidity risk exposures that the activities create;
- Actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to smooth functioning of payment and settlement systems; and
- Maintain a cushion of unencumbered, high-quality liquid assets as insurance against a range of stress scenarios.

The BCBS has come out with 17 principles on liquidity risk management which are enumerated below:

**Fundamental principle for the management and supervision of liquidity risk**

Principle 1: A bank is responsible for the sound management of liquidity risk.

**Governance of liquidity risk management**

Principle 2: A bank should clearly articulate a liquidity risk tolerance that is appropriate for its business strategy and its role in the financial system.

Principle 3: Senior management should develop a strategy, policies and practices to manage liquidity risk in accordance with the risk tolerance and to ensure that the bank maintains sufficient liquidity.

Principle 4: A bank should incorporate liquidity costs, benefits and risks in the internal pricing, performance measurement and new product approval process for all significant business activities (both on- and off-balance sheet), thereby aligning the risk-taking incentives of individual business lines with the liquidity risk exposures their activities create for the bank as a whole.

**Measurement and management of liquidity risk**

Principle 5: A bank should have a sound process for identifying, measuring, monitoring and controlling liquidity risk.

Principle 6: A bank should actively monitor and control liquidity risk exposures and funding needs within and across legal entities, business lines and currencies, taking into account legal, regulatory and operational limitations to the transferability of liquidity.

Principle 7: A bank should establish a funding strategy that provides effective diversification in the sources and tenor of funding.

Principle 8: A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems.

Principle 9: A bank should actively manage its collateral positions, differentiating between encumbered and unencumbered assets.

Principle 10: A bank should conduct stress tests on a regular basis for a variety of short-term and protracted institution-specific and market-wide stress scenarios (individually and in combination) to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity risk tolerance.

Principle 11: A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations.

Principle 12: A bank should maintain a cushion of unencumbered, high-quality liquid assets to be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of unsecured and typically available secured funding sources.

**Public disclosure**

Principle 13: A bank should publicly disclose information on a regular basis that enables market participants to make an informed judgement about the soundness of its liquidity risk management framework and liquidity position.

**The role of supervisors**

Principle 14: Supervisors should regularly perform a comprehensive assessment of a bank's overall liquidity risk management framework and liquidity position to determine whether it delivers an adequate level of resilience to liquidity stress given the bank's role in the financial system.

Principle 15: Supervisors should supplement their regular assessments of a bank's liquidity risk management framework and liquidity position by monitoring a combination of internal reports, prudential reports and market information.

Principle 16: Supervisors should intervene to require effective and timely remedial action by a bank to address deficiencies in its liquidity risk management processes or liquidity position.

Principle 17: Supervisors should communicate with other supervisors and public authorities, such as central banks, both within and across national borders, to facilitate effective co-operation regarding the supervision and oversight of liquidity risk management.

**Source**: Principles for Sound Liquidity Risk Management and Supervision – Basel Committee for Banking Supervision

of 244 bps[35] would reduce the system CRAR from 13.0 per cent to 10.9 per cent in March 2008[36]. The Panel also noted that banks' exposure to the capital market remains low and direct equity exposure is small. The stress tests of

[35] The yield volatility of fifteen-year government securities using the exponentially weighted moving average (EWMA) method was estimated at 244 bps at 99 per cent confidence interval.

[36] As per extant accounting norms, banks are required to mark to market only their trading portfolio which has been declining in recent years. While this disregard of interest rate risk in the banking books would make banks vulnerable to embedded losses, the actual impact on capital due to interest rate increase is expected to have a smaller impact on the banks' books than what has been estimated.

banks' direct exposure to the capital market revealed limited impact on banks' capital position.

It is observed that, globally, capital market exposure is measured based on risk and not quantitative limits. The Panel on Financial Regulation and Supervision observed that the capital market exposure prescriptions in India are in terms of quantitative limits. There is a need to review the capital market exposure limits, keeping in view risks arising from these exposures. The CFSA feels that though quantitative limits on capital market exposure could be one of the internationally accepted methods, the 'one size fits all' approach may not be correct and limits can be fixed individual bank-wise on a case-by-case basis depending on the individual bank's risk profile and risk mitigating capabilities.

The CFSA notes that the Reserve Bank has since issued guidelines on interest rate risk in the banking book as part of the supervisory review process under Pillar II of Basel II, which is currently applicable to banks with overseas operations and foreign banks. The guidelines would be applicable to all other banks from March 31, 2009.

The CFSA supports the stand taken by the Panel on Financial Regulation and Supervision that the Reserve Bank may issue appropriate guidelines to banks laying stress on maintenance of balance of skills between the front and the back offices of the banks' treasury departments, as also its recommendation to incorporate in the on-site inspection manual a suitable provision mandating on-site inspectors to specifically comment on this aspect in their reports.

*Operational Risk Management*

The CFSA notes that the Reserve Bank has issued guidelines to its inspecting officials whereby they should comment on implementation of policies to address operational risk. Further, it endorses the stand of the Panel on Financial Regulation and Supervision that a mechanism be put in place whereby the banks should be required to report to the Reserve Bank any developments affecting operational risk in the banks.

*Risk Modelling*

The Panel on Financial Regulation and Supervision noted that, in terms of the extant guidelines, the use of internal models for risk management is not specifically mandated. However, they feel that there is need for a rigorous model-building exercise which will enable banks to adopt a more advanced Internal Rating Based (IRB) approach in respect of credit risk and an Advanced Measurement Approach (AMA) for operational risk. Further, if a bank intends to take recourse to the IRB or AMA approach for assessing credit and operational risks, it should have appropriate forward-looking models in place which should be validated periodically. Agreeing with the Panel's views, the CFSA also recognises the need for capacity building in banks and the Reserve Bank as the prime precondition in this regard.

Capacity building, both for banks and regulators is a prime pre-condition for development of models for assessing risks.

Off-site surveillance mechanism could be augmented to collect data necessary to monitor financial stability.

*Issues Relating to Assessment of Resilience of Commercial Banks*

The resilience of the financial system can be tested by subjecting the system to stress scenarios which should ideally be linked to a macroeconomic framework. However, to establish the exact extent of the impact of changes in macroeconomic variables like real interest rates, output growth, domestic credit growth, real exchange rate and inflation rate on the variables to be stressed, further empirical analysis has to be undertaken. In the absence of adequate data to link macroeconomic scenarios with financial soundness indicators and also the lack of any 'stress events' in the Indian financial system for the past fifteen years (till September 2008), the Panel on Financial Stability Assessment and Stress Testing has done the assessment using single factor sensitivity analysis to assess the resilience of the financial system to exceptional but plausible events.

Given the limitations in carrying out multiple factor scenario-based analyses like lack of adequate time series data for several variables, no econometric models and leakages in the form of inter-bank contagion (including NBFCs), the Panel has suggested that the off-site monitoring and surveillance mechanism of the Reserve Bank could be augmented to include collection of data necessary to monitor financial stability. This would help in carrying out systematic analysis of the relationship between FSIs for non-financial corporations (and the household sector) and corresponding FSIs for the banking sector, and between FSIs and macro variables. Endorsing Mr. Sundararajan's views in this regard the Panel felt that such a forward-looking analysis of FSIs is needed, because current levels of FSIs are a lagging or at best contemporaneous indicators of financial health. Thus, the results of some standard stress tests (*e.g.*, specific increases in bench mark interest rates, or a change in exchange rate, or a shift in volatility) may be monitored periodically to capture any balance sheet deterioration over time, while carrying out scenario analysis and scenario-based stress testing in order to capture current developments.

Inter-disciplinary Financial Stability Unit to monitor systemic vulnerabilities.

The Reserve Bank has formed an internal group on financial stability/ vulnerability indicators and they are in the process of building up a time series, which will make it possible to develop models to get early warning signals, and a set of variables that can be used for stress testing. In the above context, the Panel recommended that the existing informal vulnerability group within the Reserve Bank be crystallised into an inter-disciplinary Financial Stability Unit which could periodically monitor systemic vulnerabilities. The responsibilities of the unit could broadly be:

(a) To conduct macro-prudential surveillance of the financial system.

(b) To prepare periodic financial stability reports.

(c) To develop a database in co-ordination with the supervisory wing for collection of key data in respect of variables that could impact financial stability.

(d) To develop a time series for a core set of financial soundness indicators.

(e) To conduct systemic stress tests based on plausible scenarios to assess resilience.

(f) To develop a model to assess financial stability.

The CFSA feels that the constitution of such a unit could be considered.

*Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*

Responding to the sub-prime turmoil, in April 2008 the Financial Stability Forum (FSF) presented to the G-7 Finance Ministers and central bank Governors a report making recommendations to enhance the resilience of markets and financial institutions[37]. The recommended actions are in five areas:

- Strengthened prudential oversight of capital, liquidity and risk management.
- Enhancing transparency and valuation.
- Changes in the role and uses of credit ratings.
- Strengthening the authorities' responsiveness to risks.
- Robust arrangements for dealing with stress in the financial system.

The CFSA notes that the Reserve Bank has since put in place regulatory guidelines covering many of these aspects while, in regard to others, actions are being initiated[38].

In its follow-up report on the implementation of the FSF report on enhancing market and institutional resilience, the FSF has come out with an action plan in the following additional areas:

- To monitor and address the international interaction and consistency of emergency arrangements and responses being put in place to address the current financial crisis.
- To take forward work to mitigate sources of pro-cyclicality in the financial system.

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[37] The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, which was presented to G7 Finance Ministers and Central Bank Governors in April 2008. Comments have been invited from various members.

[38] For details of the action taken, refer to the Annual Policy statement for the year 2008-09 - Reserve Bank of India.

- To reassess the scope of financial regulation, with special emphasis on currently unregulated entities.
- To better integrate macroeconomic oversight and prudential supervision.

In view of market developments, the FSF further felt that implementation of certain recommendations needs to be accelerated:

- To put in place central counterparty clearing for over-the-counter (OTC) credit derivatives and achieve more robust operational processes in OTC derivatives markets.
- To enhance and converge guidance on valuation of instruments in inactive markets, and accounting and disclosure standards for off-balance sheet activities and related risks.
- Enhancement of efforts by credit rating agencies (CRAs) to comply with the FSF recommendations.
- Private sector organisations to rigorously monitor and report on the timely implementation of improvements in industry practices.

The CFSA notes that some of the enhanced measures suggested by the FSF, *e.g.*, relating to mitigation of pro-cyclicality in regulation[39], bringing hitherto unregulated entities within the ambit of financial regulation[40], undertaking macroprudential surveillance of the financial system by forming an inter-disciplinary financial stability unit[41], improvement in accounting standards, and disclosure and transparency in respect of derivative products[42] already finds mention in the report as recommendations.

**3.2.45 Prompt Corrective Action**

The Reserve Bank has in place a scheme of Prompt Corrective Action (PCA) since December 2002 which is applicable to scheduled commercial banks (except RRBs). The scheme is in place to undertake 'structured' and 'discretionary' actions against those banks that exhibit weaknesses in certain pre-determined financial and prudential parameters.

The Panel on Financial Stability Assessment and Stress Testing has observed that, while the scheme for Prompt Corrective Action has been put in

[39] ibid Section 3.2.44

[40] ibid Section 5.2.2

[41] ibid Section 3.2.44

[42] ibid Section 4.3.23

place by the Reserve Bank, it is not transparent as to whether action has been undertaken against any bank in this regard and the circumstances that led to the same. Internationally it has been observed that while PCA programmes are normally put in place in many countries, these may or may not be publicly disclosed. The CFSA notes that there has been an improvement in the financial performance of banks over a period of time inasmuch as there are no banks at present hitting any of the PCA triggers, *viz.*, CRAR, net NPAs to net advances and Return on Assets. It also notes that as and when any bank hits the PCA, it would trigger a set of actions that is communicated to the bank which includes mandatory and discretionary actions. Further, the performance of the bank is monitored by the Reserve Bank on an ongoing basis and the position is apprised to the Board for Financial Supervision. Circumspection in disclosures by supervisors arises from the potential market reaction that it might trigger, which may cascade into a systemic risk. The CFSA therefore feels that the disclosure of the names of banks coming under the PCA framework should not be automatic and, in case any bank fails to take corrective action, the disclosure could be considered by the Board for Financial Supervision at a later stage.

The disclosure of the names of banks in trouble should not be automatic.

The Panel on Financial Stability Assessment and Stress Testing and the Panel on Financial Regulation and Supervision have also recommended that, for effective implementation and to improve its efficacy, there should be a categorically documented suitable/appropriate time-frame for the delineated action points under the scheme. The CFSA feels that the aim of the supervision when putting a supervised entity under PCA would be to nurture it back to health. It is significant that after the framework of 2002 was put in place, all banks now comply with CRAR. The key issue is that any rigidity in fixing a timeline could prove to be unduly restrictive.

The Panel on Financial Regulation and Supervision has additionally recommended such a formal preventive and corrective action framework for insurance firms. The CFSA, in addition, recommends that apart from commercial banks and insurance firms, in the interests of financial stability, such a scheme may be evolved and implemented by the Reserve Bank for co-operative banks and systemically important NBFCs, as well as by SEBI for systemically important mutual funds.

**3.2.46 Consolidation**

The Panel on Financial Stability and Stress Testing observed that competitive pressure has led to a gradual decline in the share of public sector banks in total commercial bank assets. It also notes that capital requirements could trigger another phase of consolidation in the banking industry.

PCA should also apply to insurance companies, systemically important NBFCs and mutual funds.

The Panel noted that, in the past, mergers were initiated by regulators to protect the interests of depositors of weak banks. In recent years, market-led mergers between private banks have been prominent. It is expected that this process will gain momentum in the coming years. Market-led mergers between public sector banks or public sector banks and private banks could be

the next logical development as market players consolidate their positions to remain in competition.

Consolidation can also take place through strategic alliances/ partnerships. Besides helping banks to achieve economies of scale and augment the capital base, it could help market players in other ways to strengthen their competitiveness. Alternatively, strategic alliances and collaborative approaches could be attempted to reduce transaction costs through outsourcing, leveraging synergies in operations and strengthening the work culture.

Pressure on bottom lines can prompt banks to seek consolidation in their range of services. For instance, some banks may want to shed their non-core business portfolios to other banks. This could see the emergence of niche players in different functional areas and business segments, such as housing, cards, mutual funds, insurance, and sharing of their infrastructure including Automatic Teller Machine (ATM) networks.

The Panel felt that notwithstanding the advantages, the scope for consolidation in PSBs needs to be explored with caution. In any case, the gains from consolidation and the synergies needed should be clearly quantified by the management and it is important for bank boards to track whether these gains are, in fact, being realised. It would prove useful provided suitable progress could be made on HR and, more importantly, issues of industrial relations. The Panel, therefore, felt that consolidation would prove useful only if certain enabling conditions, such as progress in terms of industrial relations and human resource issues, are adequately addressed.

The Panel also felt that the time is opportune for old private banks to explore the possibilities of consolidation, especially given that several of them are already listed. The regulators can play a pro-active role in facilitating consolidation within this segment.

The time is opportune for old private banks to explore the possibilities of consolidation.

Several committees in the past have suggested consolidation in the banking industry as one of the measures to strengthen its viability and better integration into global markets.

The Narasimham Committee (1991 and 1998) suggested mergers among strong banks both in the public and private sectors. Such mergers need to be based on synergies and locational and business-specific complementarities. The Khan Committee (1997) recommended that management and shareholders of banks and development finance institutions (DFIs) should be

permitted to explore and enter into gainful mergers. The Committee recommended mergers not only between banks, but also between banks and DFIs; and not only between strong and weak viable entities, but also between two strong banks or DFIs. The Verma Committee (1998) observed that mergers between weak banks and/or strong banks serve no purpose and might be counterproductive. Mergers should take into account synergies and complementarities of merging units, and provide opportunities for pooling of strengths. It must lead to an overall reduction in the cost of operations which will increase competitive ability, operational efficiency, better positioning and larger market share.

The Report of the Committee on Fuller Capital Account Convertibility (FCAC) recommended that the Reserve Bank should formulate its prudential policies in a manner which favours consolidation in the banking sector. The Reserve Bank should facilitate the emergence of strong and professionally managed banks, not necessarily large banks. In this context it observed that the different statutes for different segments of the banking sector have embedded provisions which hinder good governance and consolidation and recommended all PSBs should be brought under a single statute to facilitate market-driven consolidation.

The logic of consolidation in India is based on certain assumptions. One, that there are too many banks in India and, two, if the banking sector has to be assessed in the Indian context, size is the most important factor as size augments the risk-bearing capacity of banks. Banks with sub-optimal size may not be in a position to adopt appropriate technology due to size constraints. The Reserve Bank's report on Currency and Finance 2006-08 notes that, internationally, small and medium banks have been able to survive along with large banks. That said, of the 53 domestic commercial banks in India, the size of 16 banks was less than 0.5 per cent the size of the commercial banking sector. The analysis in the report suggests that the larger institutions are more efficient than the smaller ones and, therefore, consolidation of small and less efficient banks with larger and more efficient banks would serve the system better. However, the merger and acquisition process has to be driven by market forces depending upon synergies and the wishes of shareholders. In principle, efficient small banks in the Indian context could play a more active role in lending to smaller enterprises.

The CFSA notes that the imperatives of consolidation in Indian banking exhibit certain country-specific considerations. Salient considerations include the need for a larger capital base to support, *inter alia*, customer growth and larger needs, leveraging of information technology and communications networking and the blurring of the distinction between financial institutions. In this context, however, it should be noted that banks in India are heterogeneous in character and operations. This presents potent problems in the integration of infrastructure and business process/delivery mechanism, which may lead to increases in costs post-merger. Also, the differences in approaches to human resource management and industrial relations between

The advantage of banks attaining critical size requires to be juxtaposed against greater concentration risk arising out of consolidation.

the entities proposed to be merged would need to be factored in at the time of merger/amalgamation.

The CFSA feels that there is a need to look at consolidation from a holistic viewpoint, assessing the pros and cons of the process. One pertinent issue relates to catering to the increased financial needs of large corporates, which necessitates the existence of some banks having a 'critical size' to meet these funding requirements. It has to be noted that asset size-wise, Indian banks are much smaller than some of the banks in the world[43] and the loan syndication process to circumvent the problem brings with it added complications relating to co-ordination among lenders. At the same time, it should be borne in mind that consolidation could lead to greater concentration, posing systemic risks.

In this context, the CFSA notes that there are two distinct rationales behind the merger/amalgamation of commercial banks. On the one hand, the merger could be market-driven, while on the other it could be Government-led. The CFSA notes that prior to 1999 the amalgamation of banks was Government-led and was triggered by the weak financials of the bank being merged. In recent times, there have been a series of market-driven amalgamations which were primarily aimed at exploiting synergies through amalgamation. The CFSA feels that the process of consolidation needs to be primarily market-driven; this could be supported by creating a regulatory environment which would continue to be more conducive to such market-driven amalgamations. This could help reduce the capital-raising constraints of public sector banks in the short term by allowing market-driven amalgamation of PSBs, which are on the borderline of government majority holding, with other PSBs, where the government holding is significantly above the stipulated minimum. It could also facilitate the merger of any remaining smaller and weaker old private sector banks with stronger and larger banks. This issue has been discussed in detail under the section on ownership issues (Section 3.2.41).

Consolidation needs to be primarily market-driven.

[43] In the Banker's list of the top 1,000 banks of the world (July 2007) there were 27 Indian banks (compared to 20 in July 2004). Of these, 11 banks were in the top 500 banks (compared to 6 in July 2004). The combined assets of the five largest Indian banks, viz., the State Bank of India, ICICI Bank, Punjab National Bank, Canara Bank and Bank of Baroda on March 31, 2006 were about 51 per cent of the assets of the largest Chinese bank, viz., Bank of China, which was roughly 3.6 times larger than the SBI. Even in the Asian context, only one Indian bank, viz., the State Bank of India, figures in the top 25 banks based on Tier I capital, even though Indian banks offer the highest average return on capital among their Asian peers. The total assets of the SBI are less than 10 per cent of the top three banks in the world.
**Source:** Report on Currency and Finance, 2006-08.

The present regulatory framework permits voluntary and compulsory amalgamations. Voluntary amalgamation is permitted under Section 44A of the Banking Regulation Act under which the scheme of voluntary amalgamation needs to be approved individually by the board of directors of both banks and also by the Reserve Bank, and subsequently by two-thirds of the shareholders of both banks. Compulsory amalgamation arises because of the Reserve Bank directing banks under Section 45 of the Banking Regulation Act, 1949 and the cause of action arises in such cases due to public interest or the interests of depositors of a distressed bank or to secure proper management of a banking company or in the interests of the banking system. There have been a total of 33 mergers/amalgamations from November 1969 to date, of which 25 mergers involved mergers of private sector banks with public sector banks and the remainder involved private sector banks.

The Panel on Financial Stability Assessment and Stress Testing noted that the Competition (Amendment) Act, 2007 brings to the fore issues like the powers of the Commission to regulate combinations. Under the provisions of the Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for a maximum period of 210 days. Since voluntary amalgamation of banks under Section 44A of Banking Regulation Act, 1949 is at the instance of the concerned banks, it is apprehended that the aforesaid provisions may apply in such cases and, consequently, it may become necessary for the banks to give notice of a proposal for voluntary amalgamation under Section 44A of the Banking Regulation Act to the Commission and get the order of the Commission or wait for a maximum period of 210 days. The Reserve Bank may be able to consider giving sanction to the scheme of amalgamation only thereafter. This, apart from delaying the whole process, is also likely to raise regulatory conflicts. The same view may also apply in amalgamations of nationalised banks under the schemes made by the Central Government in the exercise of its powers under Section 9(2) of the Nationalisation Acts, 1970 and 1980. However, considering the gravity of the matter and its repercussions, the Panel felt that it is necessary to have a serious look into the whole issue and, if necessary, the Central Government may grant necessary exemption under Section 54 of the Competition Act. The CFSA, while concurring with the views of the Panel, notes that the matter has already been taken up by the Government[44].

There have been a total of 33 mergers/ amalgamations from November 1969 to March 2008, of which 25 mergers involved mergers of private sector banks with public sector banks.

**3.2.47 Banking Legislations**

Apart from the BR Act which governs all the scheduled commercial banks, there are various other legislations governing different bank groups. The nationalised banks are governed by two Acts, *viz.*, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The State Bank of India

[44] The CFSA notes that the Government has already taken up the matter seeking exemption from the relevant provisions of the Act with the Ministry of Corporate Affairs.

and the subsidiaries of State Bank of India are governed by two legislations, *viz.*, State Bank of India Act, 1955 and State Bank of India (Subsidiary banks) Act, 1959, respectively. IDBI Bank is governed by the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003. The private sector banks come under the purview of the Companies Act, 1956. The overall regulation of the banking sector is governed by the BR Act. The CFSA notes that since the origins of the banks have been historically different, they continue to be governed by different legislations. It also notes that the Government at various points in time has been considering the possibility of a single banking legislation to cover all public sector banks (PSBs). The CFSA feels that while a single legislation for all PSBs could be the first step forward, the Government could consider subjecting all commercial banks to a single banking legislation in a medium-term perspective.

There have been some developments that have taken place since the last assessment undertaken by the IMF and the World Bank. The Banking Regulation (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2006 provides for (a) an increase in the number of whole-time directors of nationalised banks from two to four; (b) the director to be nominated by the Government on the recommendation of the Reserve Bank to be a person possessing the necessary experience and expertise in regulation or supervision of a commercial bank, (c) removal of the provision for nominee directors from amongst the officials of SEBI/NABARD/ Public Financial Institutions; (d) nomination of up to three shareholder directors on the boards of nationalised banks on the basis of percentage of shareholding; (e) elected directors to be persons having 'fit and proper' status as per the criteria notified by the Reserve Bank from time to time; and (f) the Reserve Bank to appoint one or more additional directors, if necessary, in the interests of banking policy/public interest/interest of the bank or the depositors. In addition, the amendments empower such banks (a) to raise capital by public issue or private placement or preferential allotment of equity as well as preference shares, subject to the guidelines to be laid down by the Reserve Bank, as also (b) empower the Central Government to supersede the board of nationalised banks on the recommendation of the Reserve Bank and appointment of administrator.

The Government can consider bringing all commercial banks under a single law in the medium term.

In the area of dispute settlement, the Legal Services Authority Act, 1987 has conferred statutory basis on the *Lok Adalats* (people's courts).The Reserve Bank has consequently issued guidelines to commercial banks and financial institutions to make increasing use of the forum of Lok Adalats. As per the

earlier guidelines, banks could settle disputes involving amounts up to Rs.5 lakh through the forum of Lok Adalats. This was enhanced to Rs.20 lakh in August 2004. Further, banks have also been advised by the Reserve Bank to participate in the Lok Adalats convened by various DRTs/DRATs for resolving cases involving Rs.10 lakh and above to reduce the stock of NPAs.

There is a requirement for upward revision of the remuneration/ incentive structure of PSBs commensurate with responsibility and to be more aligned with changing times.

**3.2.48 Executive Compensation in Banking**

The Panel on Financial Stability Assessment and Stress Testing has emphasised the need to closely examine the issue of managerial compensation in the banking sector from two angles. While the Panel felt that there is a requirement for upward revision of the remuneration/incentive structure of PSBs commensurate with responsibility and to be more aligned with changing times, the Panel had also recognised the role of managerial remuneration in the financial sector leading to excessive risk-taking and adverse selection problems as evidenced in the recent sub-prime turmoil. Managers have incentives to take huge risks because of limited liability constraints: they stand to benefit from high payoffs; if the bets do not work out, shareholders and bondholders bear the loss; and in the case of eventual bail-outs, such costs may even be socialised and passed on to tax payers. Expressing concern in this regard, the Panel has pointed out that there is a need to ensure that the incentives for top management and key executives should be linked to their performance over a longer-term economic cycle and both cash and non-cash (*e.g.*, ESOPs) payments need to be monitored. Agreeing with the Panel, the CFSA recommends that in the case of banks, wherever incentives appear too high with potential for excessive risk-taking, it would be appropriate to mandate a higher level of regulatory capital.

**3.2.49 Summary**

The assessment found that commercial banks have shown a healthy growth rate and an improvement in performance as is evident from capital adequacy, asset quality, earnings and efficiency indicators. In spite of some reversals during the financial year 2008-09, the key financial indicators of the banking system do not throw up any major concern or vulnerability and the system remains resilient. The solvency of the Indian commercial banking system has been increasing. However, the increase in off-balance sheet exposures, particularly in the derivatives segment, brings to the fore issues relating to customer appropriateness and product suitability. There is also a need for better understanding of off-balance sheet liabilities of banks and better systems of accounting and disclosures, along with a centralised netting, collateral custody and clearing system.

Incentives for top management and key executives should be linked to their performance over a longer-term economic cycle.

Though there has been an increase in competition in banking over the years, PSBs remain the dominant segment in the commercial banking space. While PSBs also compete among themselves, new generation private banks are the fastest growing sector within the commercial banking sector. The argument that branch licensing policy has stifled the growth of private sector banks is thus misplaced. While the PSBs have a comparatively lower business

per employee ratio, their cost-income ratio shows a significant degree of convergence with other bank groups. Capital adequacy ratios across bank groups have remained above the regulatory minimum and NPA ratios have shown a decline. Profitability has moved to a higher plane and was significantly bolstered by higher treasury income until 2004 and higher net interest income and fee income in recent years. Operating costs have also been contained.

The stress tests have revealed that the banking system can withstand significant shocks due to changes in credit quality, interest rate and liquidity conditions. The stress testing of credit risk has revealed that the CRAR of the banks would get affected the most in the event of the 150 per cent increase in NPAs. The stress test of interest rate risk reveals that duration of equity has declined from 14 years to eight years between 2006 and 2008. In the event of an increase in interest rate by 244 basis points, from the economic value perspective, the CRAR at the system level would go down to 10.9 per cent, assuming savings deposits mature within 1 to 28 days. As the stress testing relates to an instantaneous shock and does not take into account second-round effects, and the existing accounting principles do not require marking to market of the banking book, the actual impact of such shocks can be expected to be relatively muted compared to the results derived. The analysis of liquidity risk reveals that there is a growing dependence on purchased liquidity and also an increase in the illiquid component in banks' balance sheets with greater reliance on volatile liabilities to fund asset growth.

An updated stress test for September 2008 reveals that there has not been much deterioration in the resilience of the banking system from March 2008. The stress test on credit risk for September 2008 revealed that the impact of shocks even for a 150 per cent NPA increase is still muted. A stress test of interest rate risk for September 2008 reveals that the banks are not at very significant risk from rise in interest rates. A stress test on liquidity risk reveals continued dependence on volatile liabilities as a funding source and an increase in embedded illiquidity in balance sheet.

Though the present stress tests do not take into account correlated risks due to non-availability of data and models, there is a need to develop such kinds of analysis over a period of time.

The assessment of adherence to Basel Core Principles has revealed that there are some gaps in areas of the risk management process, exposure to related parties, market risk, liquidity risk, supervisory approach and home-

host country co-operation. Some of the major recommendations to fill the gaps are:

i) The guidelines on credit risk should include credit risk arising from various financial instruments, and those on liquidity risk need to cover foreign exposures of the banks.

ii) There is a need to put in place a mechanism whereby banks can report developments affecting operational risk to the Reserve Bank.

iii) There is a need for capacity building in both banks and the Reserve Bank, before banks embark on advanced models of credit and operational risk.

iv) The Reserve Bank needs to issue guidelines whereby banks would notify it as soon as they become aware of any material information which negatively affects the fitness and propriety of board member or a member of senior management.

v) Inspectors from the Reserve Bank need to comment on whether there is an appropriate balance of skills between front and back offices for treasury operations.

vi) The ongoing financial crisis has highlighted the importance of cross-border co-operation. The G-20 had in its meeting highlighted the importance of cross-border co-operation. Hence, until a global agreement is reached on aspects relating to cross-border co-operation, there is a need to examine the pros and cons of entering into MoUs with foreign regulators as regards home-host country relationships.

The present global financial crisis has highlighted the limitations of the present BCPs inasmuch as they do not cover SIVs/NBFCs as part of the assessment nor do they cover aspects like dynamic provisioning and counter cyclical norms; hence, there is need to revisit BCPs to cover these areas.

The CFSA has addressed several issues relating to the commercial banking sector, such as the need for capital augmentation, a roadmap for foreign banks, funding of large credit growth in recent years, governance, potential liquidity issues, bank consolidation and executive compensation. The CFSA's observations and recommendations in these areas are covered in the following paragraphs.

Given that the economy is expected to grow at around 8 per cent in the medium term, PSBs need additional capital to maintain the momentum of credit growth required to fund real economic activity. This requires large contributions from the Government if its shareholding is not to come down below 51 per cent, which will have fiscal implications. Though the CFSA notes that banks have sufficient headroom for raising tier I and tier II capital, the projections done by the Advisory Panel on Financial Stability Assessment and Stress Testing based on growth in risk- weighted assets of 30 per cent reveal

that requirement for capital would be large. However, if growth in risk-weighted assets is lower at 25 per cent, the capital requirements of the banks would be manageable within the resources of the Government. Though the Government has not constrained the growth of banks for want of capital as is evident from the investment of Rs.10,000 crore in the case of the State Bank of India, the CFSA feels that an investment of Rs.10,000 crore in the form of special bonds may not be favoured from the fiscal transparency angle. To address the issue capital constraints, One of the steps that the Government could consider is amalgamating those banks which are on the borderline of 51 per cent government shareholding with banks where the government's share is significantly higher than stipulated minimum of 51 per cent. This should, however be done, keeping synergies, complementarities and regional spread of the banks proposed to be amalgamated in mind. Also, there could be a need to create an enabling environment for the Government to reduce its majority shareholding. This would enhance flexibility in the functioning of PSBs. Subsequently, a case-by-case reduction of government shareholding to below 51 per cent, which would enable them to augment their capital base, attract talent in large numbers as they would not be constrained by government pay structure and facilitate technology upgrading and lateral recruitment of specialists can be considered. Once the process of reducing government shareholding to below 51 per cent in select public sector banks is begun, such banks would be able to operate in ways similar to the new private sector banks. However, the dilution in stake should be subject to wider holding by private shareholders, all members of the board being subject to fit-and-proper criteria, and these banks being subject to the same responsibilities and continuing to undertake government agency functions.

As regards old private sector banks, there is a need for the Reserve Bank to create a conducive environment for mergers/amalgamations to enable primarily market-driven amalgamation of these entities.

The Government and the Reserve Bank need to take into account certain issues when reviewing the proposed roadmap for foreign banks, *viz.*, foreign banks to enter either through the branch or subsidiary route and the entry should be based on reciprocity; the branch licensing policy could broadly be structured on the lines of that followed in case of new private sector banks consistent with the country's WTO commitments, but be subject to reciprocity; in the case of the subsidiary route, the foreign shareholding should not exceed 74 per cent; these banks should be listed on the stock exchange; they need to have independent board members for subsidiaries;

their entry should not result in lower flow of credit to SMEs; and subsidiaries should be subject to all requirements that Indian banks are subject to.

While there is merit in allowing voting rights to be proportionate to shareholding, any shareholding in excess of the threshold 10 per cent could continue to need the prior approval of the Reserve Bank. These are consistent with practices followed in advanced financial markets.

There is a need to revisit the aspect relating to members of Board having substantial interest (substantial interest means an amount paid up exceeding Rs.5 lakh or 10 per cent of paid-up capital of the company, whichever is less). The quantitative ceiling of Rs.5 lakh could be removed and an appropriate share of paid-up capital can be stipulated. A stipulation similar in spirit to Clause 49 of the Listing Agreement, which prescribes that one-third or one-half of the Board members need to be independent directors, could also be made applicable to unlisted banks.

As regards improvements in the governance of PSBs, the following recommendations are made:

- Appropriate care requires to be taken in ensuring proper quality of directors by adhering to fit-and-proper criteria both in letter and spirit.
- Improving flexibility in decision making, unhindered by government interference.

Though the Government notes that the scope of external agencies like the CVC over the years has undergone a change and have more or less moved with the times and the existing arrangement has worked well, the CFSA felt that in case the Government remains the majority shareholder in commercial banks, there is a case for redefining the scope of influence of external agencies, like the CVC, with regard to the banking business. There may be a need to bring out a separate CVC manual in this regard. Corporate governance principles could essentially be the same across bank groups.

The Indian banking sector has witnessed a sharp pick up in credit from financial year 2004-05 onwards. Credit growth has been widespread with not much concentration risk. The period of increased credit off-take has also seen growth in sub-BPLR loans. Despite an increase in sub-BPLR loans, there has not been any deterioration in pricing or decline in interest margins of the banks. Thus, if banks were able to lend at below BPLR and also maintain interest margins, this raises concerns about the computation of BPLR.

The period under review also saw an increase in dependence on bulk deposits to fund the credit growth, which could have liquidity and profitability implications. An increase in growth in retail housing, real estate exposure as also the infrastructure sector as seen during this period has resulted in an elongation of the maturity profile of bank assets. Simultaneously, there has been a shortening of the residual maturity of liabilities leading to a higher asset-liability mismatch.

Given the marginal increase in delinquency noticed in the retail portfolio, there is a concern that the high level of retail borrowings by households in the recent past could, in conjunction with the prevalent trend of increasing interest rates, impair their repayment schedules and increase their indebtedness.

There is a need for centralisation and integration of all risks in order to monitor and mitigate the embedded risks, particularly for larger and more complex banking groups. Estimation of economic capital to help facilitate the adoption of RAROC methodology could be a way forward. The Reserve Bank needs to look in to aspect of dynamic provisioning in detail.

The rapid overall credit growth observed internationally till 2007 was more pronounced in the retail sector and led to an increase in lending to riskier borrowers. Supervisors also did not react to the situation through issuance of countercyclical prudential norms. However, in the Indian context, the Reserve Bank had cautioned banks on the need for proper risk assessments and honing of risk assessment skills. Risk weights for retail, retail estate and capital market exposures were enhanced as countercyclical measures. Provisions for standard advances on exposures to these sectors were also increased, which would help cushion the negative fallout of a cyclical downtrend. These measures have yielded results inasmuch as the impact of the sub-prime turmoil on India has been relatively subdued. The measures were reversed in November 2008 to address concerns arising out of the current economic downturn.

Given the nominal increase in NPAs in the retail sector lately, there is a need to hone credit assessment skills in retail loan administration. Credit derivatives are an essential tool for hedging and, given the capital constraints faced by the banking sector, there is a need to consider the introduction of credit risk transfer mechanisms. However, given recent incidents in international markets, there is a need to adopt a gradualist approach by sequencing the reforms and putting in place additional safeguards while adapting credit derivatives to the Indian situation. The current regulatory guidelines on credit risk management do not require the banks' credit risk management policies/strategies to include counterparty credit risk arising through various financial instruments – a gap which needs to be addressed.

The analysis of liquidity risk for banks brought to light a growing illiquidity in banks' balance sheets coupled with a growing asset liability mismatch. Banks' dependence on purchased liquidity has been increasing

over time. There is a need to strengthen liquidity management in this context. It may also be worth considering specific regulatory capital charge if a bank's dependence on purchased liquidity exceeds a defined threshold.

The liquidity stress scenario analysis carried out on the five largest banks based on their respective positions as at end-September 2008 revealed that under the worst-case scenario, as many as three banks would have exhausted their stock of liquid assets and ended up with a negative balance at the end of the third day, which could lead to systemic strain. Thus, there is a need for banks, as well as the Reserve Bank, to carry out such periodic stress testing; this is particularly true in the case of big banks which have systemic linkages and this could then be extended to other banks. Also, assessment of liquidity risk, which is part of the individual bank's internal capital adequacy assessments (ICAAP), should be supported by appropriate stress and scenario testing arising out of liquidity shocks. These can be supplemented by system-wide modelling of liquidity by using different levels of margins and risk spreads to ensure that the macro-prudential supervisor is able to identify where liquidity pressures may build up in the system as a whole, rather than in specific institutions. Also, the implementation of contagion risk management techniques, which would explicitly take into account the impact of other risks on liquidity risk, should be undertaken in a phased manner.

From the supervisory stand-point, the on-site examination process should be supplemented by a forensic 'follow the evolution of the product' approach whereby the evolution of a derivative product is followed through its origination to final holder to check whether the financial institutions, infrastructure and trading, clearing and settlement, and risk management processes along the trading chain are appropriate, with sufficient due diligence and risk controls/audit trail.

Responding to the sub-prime turmoil, the Financial Stability Forum (FSF) in April 2008 presented to the G-7 Finance Ministers and central bank governors a report making recommendations to enhance the resilience of markets and financial institutions. The Reserve Bank has since put in place regulatory guidelines covering many of these aspects while, with regard to others, actions are being initiated.

In September 2008, the Basel Committee on Banking Supervision has come out with 'Principles for Sound Liquidity Risk Management and Supervision'. It would be expedient for the Reserve Bank to consider the scope, applicability and implementation of these principles for Indian banks.

With the upturn in the interest rate cycle, banks have been actively managing their interest rate risk by reducing the duration of their assets. As the banks' exposure to the capital market remains low and direct equity exposure is small, adverse movement of this market has a limited impact on banks. As regards operational risk, a mechanism needs to be put in place, whereby banks are required to report to the Reserve Bank any developments that affect operational risk.

As regards capital market exposure, limits can be fixed bank-wise on a case-by-case basis, depending on the individual banks' risk profile and risk mitigating capabilities.

In the absence of adequate data to link macroeconomic scenarios with financial soundness indicators, and also the lack of any 'stress events' in the Indian financial system for the past 15 years, the assessment of resilience was limited to single factor sensitivity analysis. There is a requirement to work on developing a set of vulnerability indicators to facilitate model building in which early warning signals link the stress tests with appropriate macroeconomic scenarios. An inter-disciplinary Financial Stability Unit, which could periodically monitor systemic vulnerabilities, is required to be set up.

There has been improvement in the financial performance of banks over a period of time and, hence, no bank is currently hitting the PCA trigger. As disclosure of the names of banks hitting PCA triggers has systemic implications, this should not be automatic and, in case any bank fails to take corrective action, the disclosure could be considered by BFS at a later stage. Apart from commercial banks and insurance firms, in the interests of financial stability a similar scheme needs to be evolved and implemented by the Reserve Bank for co-operative banks and systemically important NBFCs as well as by SEBI and the IRDA, respectively, for mutual funds and insurance companies.

There is a need to look at consolidation from a holistic viewpoint assessing the pros and cons of the process. While Indian banks' ability to fund large loan requirements hinges on their having a 'critical size', consolidation could lead to greater concentration, thereby posing systemic risks. The process of consolidation needs to be primarily market driven, which could be supported by creating a regulatory environment that continues to be more conducive to such market-driven amalgamations.

The Competition (Amendment) Act, 2007 brings to the fore issues like the powers of the Commission to regulate combinations. Under the provisions of the Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for a maximum period of 210 days. The Reserve Bank may be able to consider giving sanction to the scheme of amalgamation only thereafter. This, apart from delaying the whole process, is also likely to raise regulatory conflicts. The Central Government should

exempt banks from Section 54 of the Competition Act. The matter has already been taken up by the Government.

The banks have continued to be managed by different legislations due to historical reasons and the Government has been considering at various points of time to bring in a single banking legislation. Hence, a single legislation for PSBs could be the way forward and Government could consider subjecting all commercial banks to a single banking legislation from a medium-term perspective.

There is a requirement for an upward revision of the remuneration/ incentive structure of PSBs commensurate with responsibilities and to be more aligned with changing times. At the same time, it should be noted that unduly high managerial remuneration in the financial sector could lead to excessive risk-taking and adverse selection problems, as seen in the recent sub-prime turmoil. In this context, there is a need to ensure that the incentives for top management and key executives are monitored and linked to their performance over a longer-term economic cycle.

## 3.3 Co-operative and Rural Banking Sector

The co-operative banking structure in India comprises urban co-operative banks and rural co-operative credit institutions. Urban co-operative banks have a single-tier structure; but rural co-operatives have a two- or three-tier structure, with some states having a unitary structure for state-level banks operating through their own branches, and others presenting a mixed picture that incorporates both unitary and federal structures. The rural co-operatives are at district and state levels, or at the state level with branches. Regional Rural Banks (RRBs) form the other important segment of the rural financial sector. They were conceived as institutions that combine the local feel and familiarity of the co-operatives with the business capabilities of commercial banks. This sector has an exclusive role in improving financial inclusion and catering to vital sectors, like agriculture and allied economic activities. Public policy, therefore, aims at keeping this sector viable and strong through various forms of active intervention.

Co-operative banks, with an asset base of 7.4 per cent of financial institutions in March 2008, have been facing increasing competition from the commercial banking and non-banking financial sectors. In order to remain in the reckoning, there is an urgent need for these institutions to innovate and bring about attitudinal changes in management and employees, which could lead to flexibility in operations and the adoption and leveraging of new technology in their operations. The complex structure of the rural co-operative banks has cost implications, which also need to be addressed expeditiously. Due to financial impairment, the traditional role of the co-operative credit structure in meeting the rapidly growing credit needs of the weaker sections needs to be restored in order to achieve financial inclusion objectives.

The size of the co-operative and the rural financial sector in India remains small compared to commercial banks. Also, the financial performance of the co-operative sector is less than satisfactory in certain aspects. Mr. Sundararajan, the peer reviewer on the Advisory Panel report on Financial Stability and Stress Testing, felt that while the rural and urban co-operative banks and regional rural banks are financially weak, they are still collectively small and do not pose systemic risks. The CFSA notes however that though the size of the co-operative sector is relatively small, they are a part of the payment system and the risk of contagion remains.

### 3.3.1 Major Cross-cutting Issues

The Panels on Financial Stability Assessment and Stress Testing and Financial Regulation and Supervision have analysed the issues pertaining to the co-operative banking sector and the RRBs. The major cross-cutting issues that emanate from their analyses relate to:

- Dual control;
- Triangular regulation and supervision of the rural banking structure;
- Impairment in governance and management;
- Capital adequacy; and
- Licensing of co-operative institutions.

#### 3.3.11 Dual control in co-operative banking

The single most important regulatory and supervisory weakness that persists in the co-operative banking sector is the prevalence of dual control. While incorporation/registration and management-related activities are regulated in the states by the Registrar of Co-operative Societies or the Central Registrar of Co-operative Societies (for multi-state co-operative banks), banking-related activities are under the regulatory/supervisory purview of the Reserve Bank of India or NABARD. The basic issue is that co-operation is a state subject under the Indian Constitution and, as such, 'co-operatives' as a form of organisation are governed by the State Co-operative Societies Act, irrespective of whether they are banks or other forms of co-operative entities.

Though the size of co-operative sector is small, the risk of contagion remains.

The CFSA notes that this duality of control and the absence of a clear demarcation of functions between the regulators have engaged the attention of a number of committees in the past. While in the case of commercial banks the Reserve Bank has the powers under the Banking Regulation Act to deal

with crucial aspects of functioning such as supersession of the board of directors, appointment of liquidators, initiating action for removal of the CEO/Chairman of a bank, instituting special audits, and conducting statutory audit through external chartered accountants, in the case of co-operative banks these powers are subordinated in a way by the requirement that all such actions would require the intervention/approval of the Registrar of Co-operative Societies of the respective State Governments or the Central Registrar of Co-operative Societies, as the case may be.

Duality of control affects the quality of supervision and regulation of co-operative banks.

This duality of control affects the quality of supervision and regulation, and it also affects the functioning of co-operative banks. On the one hand, the regulatory weakness fosters inefficiency and impedes the development of governance principles, while on the other hand it burdens the banks with multiple levels of compliance and reporting requirements. In this context, the Advisory Panel on Financial Stability Assessment and Stress Testing observed that multiple command centres and the absence of clear delineation and separation of the functions of governments and the Reserve Bank leave significant scope for strengthening regulatory/supervisory efficacy. Mr. Eric Rosengren, peer reviewer of the Panel Report on Financial Regulation and Supervision, felt that the local government's role in the operation of co-operative societies and how their involvement affects the ability of the Reserve Bank to carry out its regulatory and supervisory duties need to be elaborated on and clarified. He felt that undue governmental influence can lead to poor governance and render regulation ineffectual, which clearly has a direct bearing on the regulator's ability to enforce compliance with Basel Core Principles. Moreover, it can be a hindrance to economic development.

The CFSA notes that the problems arising out of duality of control have been addressed by several committees and the Reserve Bank has been strategically finding solutions within the existing constitutional and legal framework. In order to mitigate this problem, the Reserve Bank has entered into MoUs with State Governments on a voluntary basis by which a Task Force for Urban Co-operative Banks (TAFCUB), comprising representatives of the state government, federation of UCBs and the Reserve Bank[45], has been set up under the Regional Director of the Reserve Bank in each state, establishing a consultative approach to regulation and supervision of the UCBs. Similarly, in the case of rural co-operative banks, MoUs have been entered into by the majority of State Governments with NABARD, under a package recommended by the Vaidyanathan Committee.

Undue governmental influence can lead to poor governance in co-operative sector.

The Advisory Panel on Financial Regulation and Supervision has recommended that though entering into such MoUs is currently appropriate and mitigates the problem to some extent in the medium term, in the interests of strengthening the sector, regulatory and supervisory powers should ultimately be vested with a 'single regulator'. Given that it is the

[45] In the case of urban co-operative banks that have a multi-state presence, the MoU has been signed between the Reserve Bank and Central Registrar of Co-operative Societies.

There is no pressing need to rush towards a single regulator for co-operatives.

compulsions arising out of constitutional and other statutory obligations that lead to the duality of control, and co-operatives traditionally have become part of state administrative machinery, the CFSA is of the view that, as a viable solution, the current arrangement of MoUs between the regulators and the Government has been working well. Therefore, there may not be any rush to move towards the system of a 'single regulator' that would require comprehensive constitutional and legislative amendments and also a significant political consensus, which are difficult to attain in the Indian context. To date, in the case of UCBs, MoUs have already been signed with 24 state governments and the Central Registrar of Co-operative Societies, accounting for 98.7 per cent of the UCBs in the country and covering 99.3 per cent of their business. Similarly, in the case of State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs), a total of 25 state Governments have entered into MoUs with NABARD. The CFSA urges that the role played by the Task Force for Urban Co-operative Banks (TAFCUB) should be continuously monitored so that it evolves with changing circumstances and withstands the test of time.

Looking ahead, the CFSA also feels that the structure of these MoUs could be examined in greater detail to include therein, in a more granular manner, further issues of regulatory co-operation between the regulators and the Government, with the objective of further strengthening the overall regulatory purview, particularly in respect of critical areas such as governance principles. The CFSA also feels that it is necessary to re-look at the uniform format of the MoU and, if needed, differentiate the format in the case of individual State Governments/Central Government in order to fine tune it with selective deviations that suit the requirements of individual states/ institutions, without diluting the sound principles of the uniform format.

### 3.3.12 Triangular Regulation and Supervision of the Rural Banking Structure

The MoU format could be differentiated so as to suit specific requirements of states without diluting the sound principles of the uniform format.

The Advisory Panel on Financial Stability Assessment and Stress Testing noted that in the case of the rural banking sector, apart from the presence of the Registrar of Co-operative Societies for incorporation/registration-related regulation, banking regulation is further split between the Reserve Bank, which has the regulatory powers, and NABARD, which is vested with the supervisory responsibility. The shortcomings of this segregation of regulatory and supervisory roles is compounded by the fact that NABARD has limited powers of enforcement of its supervisory findings, for which it has to depend

on either its own persuasiveness or seek action through interventions by the Reserve Bank or state Government. The Panel recommended that the supervisory powers of NABARD needs to be enhanced.

NABARD derives its supervisory powers from the Banking Regulation Act. Considering that divestment of the Reserve Bank's capital stake in NABARD is now being envisaged, the question arises whether both regulation and supervision of all rural banks should lie with the Reserve Bank, which is also empowered under the Banking Regulation Act to supervise these entities. The CFSA notes that a recommendation was made by the *Internal Working Group on RRBs,* constituted by the Reserve Bank (Sardesai Committee) in 2005 that both functions in respect of RRBs should be brought under the purview of the Reserve Bank, because there is a potential conflict of interest between the supervisory and development functions of NABARD. The Sardesai Committee also felt that by virtue of their 'scheduled' status, it would be more appropriate for these entities to be supervised by the Reserve Bank.

There is a view in this regard that the present arrangement wherein NABARD as well as the Reserve Bank both have well-defined roles in terms of the RBI Act, 1934 and RRBs Act, 1976, need not be disturbed as of now. The CFSA, however, feels that this issue needs to be addressed from the angles of conflict of interest, cost and supervisory efficiency, and a considered view needs to be taken by the Reserve Bank. The CFSA is of the view that the role of NABARD as a Development Financial Institution (DFI) and regulator/ supervisor of rural financial institutions may be considered to be segregated appropriately, so that NABARD will exclusively function as a specialised DFI. As regards regulation and supervision, the CFSA feels that for RRBs the recommendation of the Sardesai Committee can be considered. The Government feels that the question of supervision of RRBs by the Reserve Bank was earlier examined on a reference received from the Reserve Bank. On viewing the proposal in entirety, it was decided that the present arrangement may not be disturbed as of now.

As regards regulation and supervision of rural co-operative banks, the CFSA feels that given the large number of such institutions in the rural financial landscape, it may become onerous for the Reserve Bank to take over both regulatory and supervisory responsibility for the rural co-operative sector. One option could be to strengthen their regulatory and supervisory structure by transferring the task to a separate regulatory authority, which could have a Board of Supervision with members drawn from the NABARD Board as also persons with regulatory/supervisory experience. The Board will have the responsibility to ensure that capital is not eroded and the banks maintain minimum audit and capital requirements by having an effective system of proper reporting, early warning signals and prompt corrective action. The separate body can be promoted by the Government and the Reserve Bank.

In the interest of harmonisation of regulatory principles across the banking sector and minimisation of the scope for regulatory arbitrage, the

proposed body may need to function in close co-ordination with the Reserve Bank. Also, the new regulator will need to partner with the Reserve Bank on matters of systemic importance, such as participation in payment and settlement systems, deposit insurance, and anti-money laundering. To this end, the CFSA feels that appropriate legislative amendments could be considered in setting up such an authority.

**3.3.13 Impairment in Governance and Management**

A unique feature of the co-operative banking system in India is that borrowers have a significant say in the management of the bank. This follows from the fact that only borrowers of the co-operative bank are eligible to be its members, contributing to share capital. This is a cause for concern, as the Board members of the bank are elected by borrowers, resulting in the policies of the bank not always being in congruence with the interests of depositors. In view of the propensity of these banks to pursue borrower-oriented policies rather than policies that should be in favour of protecting depositors' interests, the Panel on Financial Stability Assessment and Stress Testing has suggested that the involvement of depositors in the management of these banks should be enhanced by encouraging membership of depositors on par with borrowers.

Another reason for impairment of governance in the co-operative banking structure is attributed to interference in matters related to appointment of directors on the basis of political affiliations rather than on merit. This manifests itself in lack of professional expertise at the board level and interference in decision making, particularly in respect of loan sanctions. This impairs the financial health of co-operative banks.

In the case of rural co-operative banks, it has been observed that the prevalence of the three-tiered structure leads to an increase in transaction costs that diminish profit margins. Also, there is considerable interference by the elected board in the day-to-day management of these banks, which ordinarily should be the responsibility of the Chief Executive Officer. Further, officials from the state government deputed to these banks may have neither the professional skills nor the requisite experience to run the banks, though recent initiatives of incorporating fit-and-proper criteria for the CEO and directors in the MoU is expected to alleviate this problem.

The depositors should be involved in the management of co-operative banks.

The Advisory Panel on Financial Stability Assessment and Stress Testing observed that, while the Reserve Bank has powers to delineate the role of the directors, since the power of taking action against these directors or the board

is vested with the State/Central Government, it would be desirable to bring aspects related to management of these banks within the ambit of Banking Regulation Act; this would create a conducive environment for enhancing professionalism in the management of these banks.

The Advisory Panel on Financial Regulation and Supervision had, in a similar vein, suggested that the Reserve Bank needs to review the current system of corporate governance in these banks and issue the appropriate guidelines. Currently, the Reserve Bank does not have the power to appoint external experts including auditors to conduct supervisory tasks. Auditors are not required to bring to the notice of the Reserve Bank any material shortcomings identified during the course of their work. Aspects relating to audit are attended to by the Registrar of Co-operative Societies (RCS). As per MoUs signed between the Reserve Bank and the RCS, state Governments are required to provide for a statutory audit by chartered accountants appointed in consultation with the Reserve Bank for UCBs with deposits of over Rs.25 crore.

The Panel recommended that the Reserve Bank, in consultation with State Governments and the ICAI, explore the possibility of making it mandatory for external auditors to notify the Reserve Bank of any adverse developments that come to their notice during the course of their audit. From a longer-term perspective, however, powers similar to those vested with the Reserve Bank under Section 30 of the Banking Regulation Act as applicable to commercial banks should form part of the MoU with State Governments, so as to alleviate the problems relating to auditors faced by the Reserve Bank (such as appointment or removal of an auditor with the prior consent of the Reserve Bank or conducting a special audit of a bank, if necessary, in the interests of depositors).

The Reserve Bank/NABARD do not have the powers to require changes in the composition of the board and senior management of RRBs to address prudential concerns. Since the composition of the boards of RRBs is in accordance with the provisions of the Regional Rural Banks Act, 1976, wherein nomination to the board is made with the due approval of the Central Government, any change in this regard would require an amendment to the Act. Hence, there is no need for any change at the current juncture.

Corporate governance in the strictest sense of the term has not so far been made applicable to RRBs, as the board members are generally nominated. Nor have they been made accountable for all omissions and commissions. Though directors are nominated to RRBs, it would be desirable to make them accountable. There should be a formal board-approved policy in this regard. The Government however, feels that the RRB Boards take collective decisions and each director, whether nominated or otherwise, is equally responsible for decisions.

The CFSA is in agreement with the views of the Advisory Panels on the above issues and recommends consideration of these suggestions by the

Reserve Bank and the Government. Further, it recommends that to introduce greater professionalism and as a best practices guide for corporate governance, co-operative banks should consider following the best governance principles as enunciated by the World Council of Credit Unions[46], because credit unions are similar to urban co-operative banks (Box 3.5). Mr. Sundararajan, the peer reviewer, also felt that speedy implementation of the identified improvements in the supervisory regime and governance arrangements would be critical to the stability and development of these institutions.

### 3.3.14 Capital Adequacy

In conjunction with the reforms pertaining to commercial banks, the promotion of prudent financial policies and practices in co-operative banks

**Box 3.5: World Council of Credit Unions - Principles of Credit Union Governance**

Credit unions are democratic, member-owned financial co-operatives that are similar in features to the urban co-operative banks in India. Credit unions have been created to serve their members and communities. As not-for-profit co-operative institutions, credit unions use excess earnings to offer members more affordable loans, a higher return on savings, lower fees or new products and services. They serve members from all walks of life, including the poor and disenfranchised. Each member, regardless of account size in the credit union, is eligible to stand for the board elections as well as cast his vote. As financial intermediaries, credit unions finance their loan portfolios by mobilising member savings and shares rather than using outside capital, thus providing opportunities for future generations of members.

In pursuit of its vision of 'Quality Credit Unions for Everyone,' the mission of World Council of Credit Unions (WOCCU) is to assist its members and potential members to organise, expand, improve and integrate credit unions and related institutions as effective instruments for the economic and social development of all people. WOCCU has introduced the International Principles of Credit Union Governance which address the challenges of organisational power within credit unions at three separate levels: external, internal and individual. The Board and managers, as a cohesive unit, ensure the credit union's compliance with issues related to external and internal governance. To achieve this goal, each Board member has a duty to adhere to the principles of individual governance.

The International Principles of Credit Union Governance cover separate sections on (a) Board of Directors' Duties & Responsibilities, (b) Code of Conduct, (c) Credit Committee Duties & Responsibilities, (d) Credit Union Governance, (e) Governance Principles for Credit Unions, (f) Model Credit Union Bylaws, (g) Operational Management, (h) Problem Resolution and (i) Supervisory Committee Duties & Responsibilities.

Source : http://www.woccu.org/bestpractices/governance.

Best governance principles as enunciated by the World Council of Credit Union could be considered.

[46] World Council of Credit Unions is a leading international trade association and development agency for credit unions.

was seen as a *sine qua non*. The adequacy of capital has traditionally been regarded as a core sign of banking strength, irrespective of whether the institution is owned by the Government or otherwise[47]. Most regulatory authorities have, therefore, adopted the requirement of capital as a ratio to risk-weighted assets for the assessment of capital adequacy. In this context, the Vaidyanathan Committee[48] noted that co-operative banks (apart from urban co-operative banks) at present continued to remain outside the CRAR (capital to risk-weighted assets ratio) framework.

The Reserve Bank should issue guidelines for scheduled UCBs on capital charge for market risk.

In the case of UCBs, the Panel on Financial Regulation and Supervision had observed that these banks are presently Basel I compliant, excepting in relation to a capital charge for market risk[49]. The Panel has recommended that the Reserve Bank should issue guidelines on capital charge for market risk for scheduled UCBs. On a similar note, the Panel on Financial Stability Assessment and Stress Testing had observed that, since the scheduled UCBs are equivalent in size and systemic importance to medium-sized commercial banks, there is a requirement to assign duration-based capital charges for market risk for such UCBs. The CFSA in this context feels that the Reserve Bank should consider implementing these suggestions. Also, given the perceived vulnerability of smaller banks, mandated CRAR could be inversely related to the size of the bank, *i.e.*, the smaller the bank, the higher its CRAR requirements.

In the case of rural co-operative banks, which include the DCCBs and StCBs, risk weight-based capital adequacy norms have not yet been made applicable, though these entities are subject to the norm of a minimum amount of capital. The Panel on Financial Regulation and Supervision and the Panel on Financial Stability Assessment and Stress Testing had recommended that the suggestion by the Vaidyanathan Committee to introduce a risk weight-based capital requirement of 7 per cent should be implemented. The Panel on Financial Regulation and Supervision has further suggested that the capital requirement for these banks be increased in a phased manner to 9 per cent as in the case of commercial banks. The CFSA feels that the recommendation for introducing a risk-based capital requirement for these banks could be considered. However, keeping in mind the scale of operations and purpose of these banks, it recommends that such prudential measures be brought into play only after completing the process of recapitalisation of these banks.

Rural co-operative banks need to be recapitalised before risk-based capital adequacy norms are imposed.

Risk-based capital adequacy norms have not so far been made applicable to RRBs. The minimum capital requirement in absolute terms has been spelt out in the Regional Rural Banks Act, 1976. The Panel on Financial Regulation

[47] Narasimham Committee, 1998.

[48] Task Force on Revival of Co-operative Credit Institutions, December 2004.

[49] Currently the UCBs are mandated to employ the 'surrogate method' to capture market risk. Under the surrogate method, additional risk weight of 2.5 per cent in respect of investments, in addition to risk weights applicable for credit risk, is assigned.

Introduction of risk based capital adequacy norms for RRBs can be considered after consolidation.

and Supervision recommended the introduction of CRAR as per Basel I which is envisaged, along with the recapitalisation of RRBs, in a phased manner after completion of the consolidation process in respect of these entities.

Despite much impairment which needs to be mitigated, the CFSA recognises the special place for the rural and co-operative banking structure with its unparalleled outreach to outlets located in small urban centers and inaccessible rural areas, and with a major part of its clientele drawn from the urban and rural poor. The CFSA believes that co-operatives and RRBs have the potential to transform the way banking is conducted in rural India. Its network makes it a major vehicle for the continuous expansion of the outreach in the country through financial inclusion. As a result, there is a need to buttress this sector to enable it to compete effectively with other financial entities.

**3.3.15 Licensing of co-operative Institutions**

Section 7 of the Banking Regulation Act, 1949 (AACS) prohibits the use of the words 'bank', 'banker' or 'banking' by any co-operative society other than a co-operative bank as part of its name. However, this provision does not apply to a primary agricultural credit society (PACS) or a primary credit society (PCS). The licensing criteria for banks which are consistent with ongoing supervision are laid down clearly in Section 22 of the Banking Regulation Act (AACS), 1949. The Act provides for automatic conversion of a primary credit society, with banking as one of its main activities, into a primary (urban) co-operative bank. Although they are required to apply to the Reserve Bank within three months of attaining capital plus reserves of Rs.1 lakh for a licence under Section 22 of the Banking Regulation Act (AACS), 1949, they can carry on banking business unless the licence application is refused. This has led to the presence of a large number of unlicensed banks.

A roadmap for phasing out unlicensed co-operative institutions functioning as banks needs to be in place.

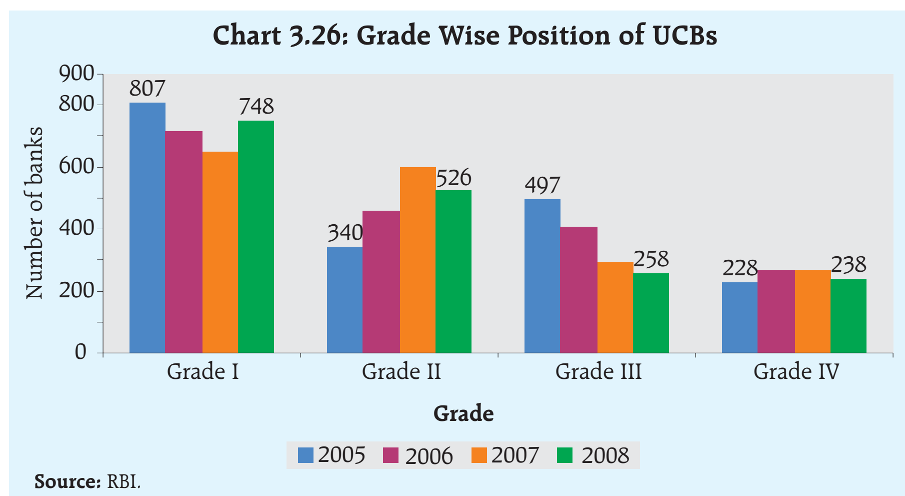
There are around 309 StCBs and DCCBs and 79 UCBs which are currently operating without a banking license. The Advisory Panel on Financial Regulation and Supervision expressed concern regarding the continued existence of unlicensed co-operative institutions, as these entities pose a risk to depositors' interests. There is a need to draw up a roadmap whereby 'banks' which fail to obtain a license by 2012 would not be allowed to operate. This would expedite the process of consolidating and weeding out non-viable entities from the co-operative space. The CFSA feels that the views of the Panel could be considered.

### 3.3.2 Urban Co-operative Banks (UCBs)

### 3.3.21 Performance

To determine the frequency of supervision, UCBs are divided into four grades based on financial parameters like CRAR, Net NPA, Net Profit and compliance with CRR/SLR requirements. While Grades I and II can be categorised as the stronger banks, Grades III and IV broadly correspond with the weak and sick category of banks. The total number of Grade I and II banks has shown an increase and Grades III and IV have shown a decrease during the past three years, which is indicative of overall improvement in their performance (Chart 3.26).

**Chart 3.26: Grade Wise Position of UCBs**

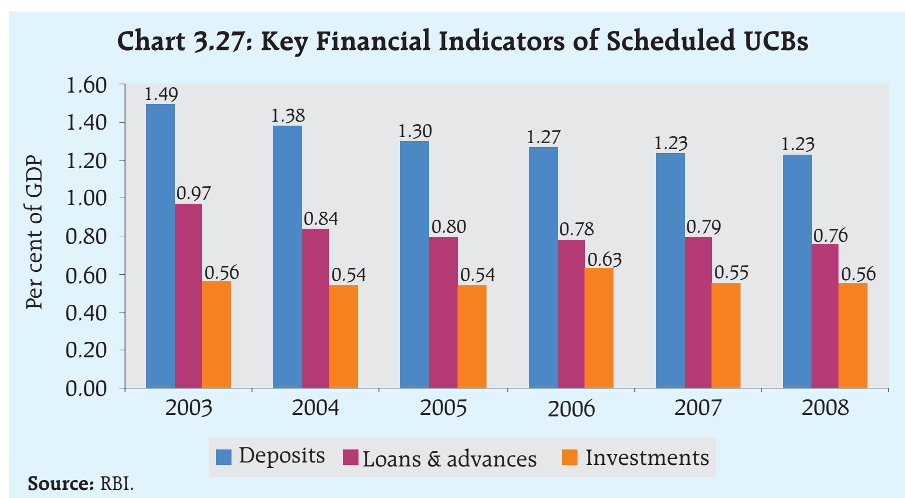



**Source:** RBI.

*Business Size*

Between end-March 2005 and end-March 2008, UCBs registered a compounded annual growth rate of 10.7 per cent. Fifty-three out of 1770 UCBs were scheduled banks. The scheduled urban co-operative banks (SUCBs) constituted about 41.8 per cent of deposits and 40 per cent of advances as on March 31, 2008 (Chart 3.27).

**Chart 3.27: Key Financial Indicators of Scheduled UCBs**




**Source:** RBI.

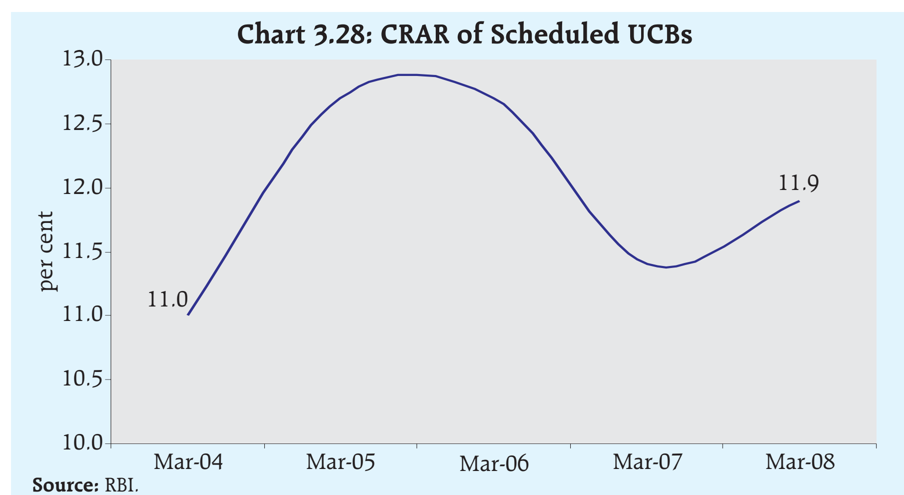
UCBs has shown improvement in overall performance.

Deposits have been the dominant funding source of these banks. Almost 50 per cent of the portfolio comprises loan assets, the other major component being investment.

*Capital Adequacy*

Though above regulatory requirement, the average CRAR of scheduled UCBs has shown some decline at end-March 2007. The CRAR has again increased by end March 2008 (Chart 3.28).

**Chart 3.28: CRAR of Scheduled UCBs**

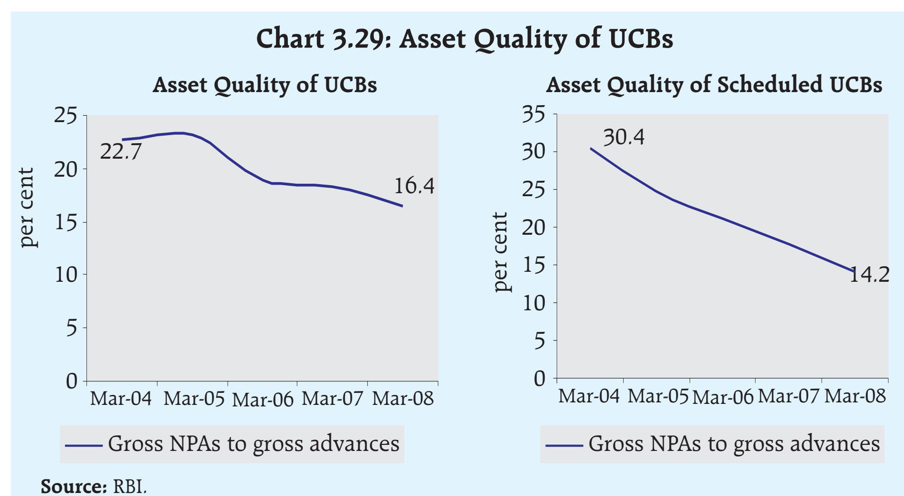



**Source:** RBI.

*Asset Quality*

Though declining, the high levels of Gross NPA for the sector throw up some concern (Chart 3.29).

**Chart 3.29: Asset Quality of UCBs**

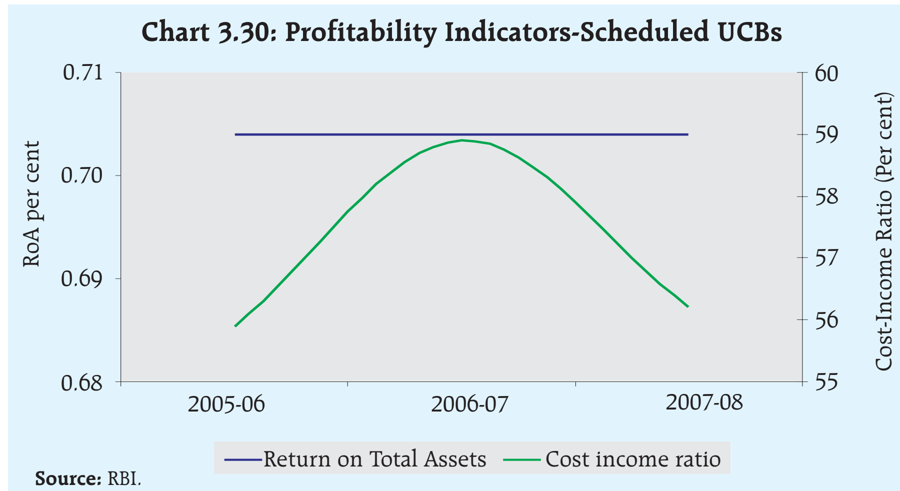



**Source:** RBI.

*Earnings and Profitability*

Return on Assets for UCBs have been hovering around 0.7 per cent between 2005-06 and 2007-08. The cost-income ratio of scheduled UCBs ranged between 55 and 67 per cent between 2004-05 and 2007-08 (Chart 3.30).

**Chart 3.30: Profitability Indicators-Scheduled UCBs**



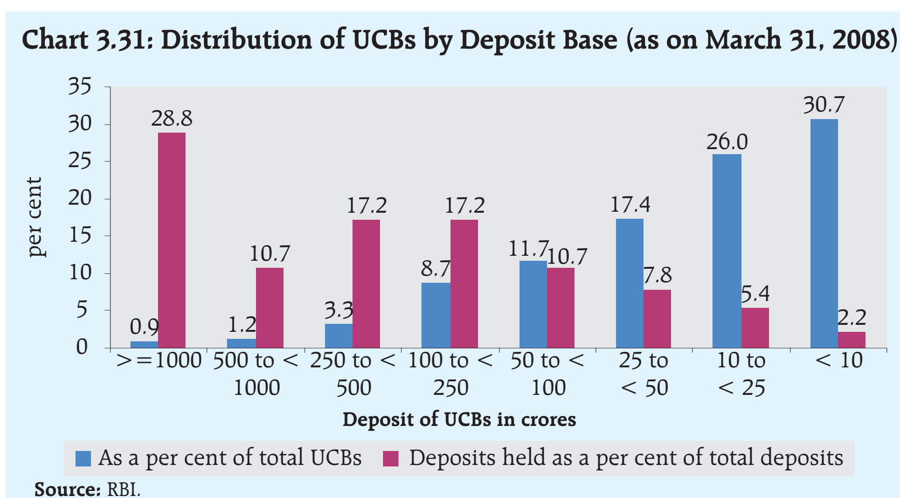

**Source:** RBI.

*Consolidation*

As 85.8 per cent of UCBs had a deposit base of less than Rs.100 crore (March 2008), there could be a need to consider consolidation among these UCBs (Chart 3.31). In addition to benefits arising out of the economies of scale in operations, a lower number of UCBs could facilitate more focused regulation and supervision of these entities.

Around 97 per cent of UCBs are non-scheduled. These UCBs account for 55.8 per cent of total assets, 58.2 per cent of total deposits and 60.0 per cent of total advances. The size of non-scheduled UCBs is generally smaller than their scheduled counterparts and these entities, particularly the smaller ones, are typically subject to less stringent prudential norms. Consolidation could bring

**Chart 3.31: Distribution of UCBs by Deposit Base (as on March 31, 2008)**




**Source:** RBI.

There is a need to consider consolidation of UCBs.

> Consolidation should be undertaken cautiously and in a non-disruptive manner.

greater harmony in prudential norms and be instrumental in strengthening the sector. However, the process of consolidation should be undertaken cautiously and in a non-disruptive manner, keeping in view ground realities. Also, the consolidation process should not result in the local population, which was served by the smaller banks, going out of the ambit of banking.

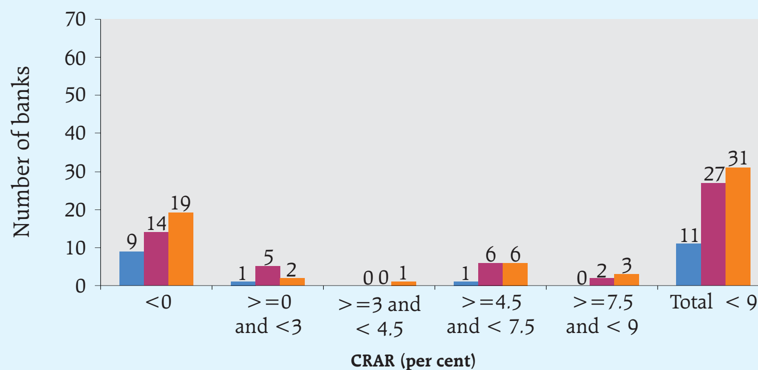
### 3.3.22 Resilience

*Stress Testing*

Given the data limitations in the sector, stress tests on 52 scheduled urban co-operative banks accounting for 43 per cent of the total assets in March 2007 of the sector were carried out. Unlike commercial banks, the tests conducted were restricted to the credit portfolio of the banks. The shocks in the credit portfolio were administered by increasing the provisioning requirement and subjecting the credit portfolio to a 25 per cent and 50 per cent increase in non-performing assets. The assumptions were similar to Scenario I of the stress tests on the credit portfolio of commercial banks. The tests revealed that as at end-March 2007, 27 banks (accounting for 38 per cent of scheduled UCBs' assets) would not be able to comply with the 9 per cent CRAR norm if the NPA levels increased by 25 per cent. At the system level, the CRAR declined from 11.4 per cent to 5.6 per cent at 25 per cent stress, pointing to the fragility inherent in this segment. When the NPA levels were assumed to increase by 50 per cent, the number of banks that would not be able to maintain the stipulated CRAR would increase to 31. The post-shock CRAR would be 2.8 per cent (Chart 3.32).

> Stress tests of the credit portfolio of UCBs revealed a fragility inherent in this segment.

**Chart 3.32: Stress Testing Results - Credit Risk - Scheduled UCB**




**Source:** RBI.

### 3.3.23 Issues and Concerns

Based on the assessment of Basel Core Principles (the details of which are furnished in Annex- Section I), wherever the adherence is not compliant or materially non-compliant, the Advisory Panel on Financial Regulation and Supervision made appropriate recommendations which are summarised below:

**Review of Risk Management**

The Reserve Bank needs to review the current system of risk management that is in place for UCBs and issue appropriate guidelines.

*Market Risk*

No guidelines on market risk have been issued except valuation norms for investments and Asset Liability Management guidelines related to interest rate risk to scheduled UCBs. No guidelines on stress testing, scenario analysis or contingency planning have been issued to UCBs. The Reserve Bank should issue guidelines on capital charge for market risk and encourage usage of sensitivity and Value at Risk (VaR) limits as risk mitigation techniques to scheduled UCBs.

*Liquidity Risk*

The ALM guidelines on structural liquidity that are applicable to scheduled urban co-operative banks do not take into account undrawn commitments and other off-balance sheet items. Furthermore, the UCBs do not have policies and processes in place for ongoing measurement and monitoring of liquidity requirements. The Reserve Bank needs to revise the ALM guidelines on structural liquidity that were issued to larger and scheduled UCBs to take into account undrawn commitments and other off-balance sheet items. These entities should be also advised to adopt policies and processes for ongoing measurement and monitoring of liquidity risk.

*Operational Risk*

The Reserve Bank has issued guidelines on the prevention and reporting of fraud, internal/concurrent audit and balancing of books. However, no specific guidelines have been issued as regards the operational risk to UCBs. Given their size and the fact that they have not yet fully implemented Basel I (capital charge for market risk), it would be premature to issue guidelines related to earmarking capital for operational risk based on the Basel II approach. However, basic guidelines on operational risk management should be considered to be issued for larger UCBs.

*Interest Rate Risk in Banking Book*

No specific guidelines have been prescribed for the management of interest rate risk, other than asset liability management guidelines. Given their size and the fact that they have not yet fully implemented Basel I, it would be premature to issue guidelines on interest rate risk in banking book to these entities.

ALM guidelines for UCBs should take into account off-balance sheet items.

### Internal control

Some of the recommendations relating to internal control are delineated below.

*Notification to Supervisor of Material Information*

The existing guidelines do not require UCBs to notify the Reserve Bank/ Registrar of Co-operative Societies (RCS) as soon as they become aware of any material information which may negatively affect the fitness and propriety of any Board member or member of the senior management. Guidelines in this regard should be issued.

*Appropriate Balance of Skills between Front and Back Office*

The Reserve Bank does not determine whether there is an appropriate balance in skills and resources of back office and control functions relative to the front office, in the case of UCBs. It does not make an assessment of the skills of bank employees. The Reserve Bank should issue guidelines to the larger UCBs on the segregation of duties and responsibilities in the front office, middle office and back office for treasury operations in respect of scheduled UCBs. Further, the Reserve Bank should make it necessary for its on-site inspection teams to look into this aspect in greater depth and comment on the same in their reports. There should be additional disclosure requirements on the reporting of derivatives and ALM for these entities.

***Accounting and Disclosure and KYC Related Issues.***

*Notification by External Auditor to the Supervisor*

Currently, the Reserve Bank does not have any power to appoint external experts, including auditors, to conduct supervisory tasks. These auditors are not required to bring to the notice of the Reserve Bank any material shortcoming identified during the course of their work. Aspects relating to audits are attended to by the RCS. As per the MoUs signed between the Reserve Bank and the RCS, state Governments are required to provide for statutory audit by chartered accountants, appointed in consultation with the Reserve Bank, for UCBs with deposits of over Rs.25 crore. The Reserve Bank has entered into MoUs with 24 states and the Central Government; it should sign MoUs with the remaining state Governments. The Panel also recommended that the Reserve Bank, in consultation with the state Governments and Institute of Chartered Accountants of India (ICAI), could explore the possibility of making it mandatory for external auditors to notify the Reserve Bank of any adverse developments that come to their notice

during the course of their audit. From a longer-term perspective, however, the powers similar to those vested with the Reserve Bank under Section 30 of the Banking Regulation Act, as applicable to commercial banks, should form part of the MoU with state Governments.

There should be additional disclosure requirements on the reporting of derivatives and ALM for larger scheduled UCBs.

*Abuse of Financial Services*

The Reserve Bank has issued detailed guidelines on Know Your Customer (KYC) to urban co-operative banks. However, there are no guidelines in place which protect bank staff who report suspicious activity in good faith, either internally or directly, to the relevant authority. Appropriate guidelines in this regard should be issued.

*Disclosures in Balance Sheet*

As per existing guidelines, the disclosures for UCBs in their balance sheet is limited to CRAR, investments, advances against real estate/shares/debentures/directors/relatives, cost of deposits, NPAs, profitability indicators and provisions. Enhancement in the disclosure norms for UCBs is recommended, which could include quantitative disclosures regarding tier I and tier II capital, non-SLR investments, exposure to capital market, and loans subject to restructuring for larger UCBs. Furthermore, given the fact that some of the larger scheduled UCBs have made forays into derivatives, there should be additional disclosure requirements on the reporting of derivatives and ALM for these entities.

The CFSA is of the view that all the above recommendations should be considered by the Reserve Bank in consultation with the Government, where necessary.

**3.3.3 Rural co-operatives**

**3.3.31 Performance**

Several concerns beset the rural co-operative banking segment. These institutions are fraught with low resource bases, inadequate business diversification and recoveries, high levels of accumulated losses, weak management information systems (MIS) and poor internal controls. As a result, this sector remains one of the weak links in the Indian financial landscape. The analysis of performance is restricted to State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) – institutions within the regulatory ambit of the Reserve Bank.

Rural co-operatives are among the weakest links in the Indian financial system.

*Business Size*

StCBs witnessed a CAGR of 8.1 per cent between March 2004 and March 2007 in their assets base, which is lower than other financial institutions like commercial banks or NBFCs. While the major source of funds of these institutions has been deposits, borrowings have also been increasing. Loans and advances are the major area of asset deployment (Table 3.17).

**Table 3.17: State Co-operative Banks – Liabilities and Assets**

(Rs. crore)

| | Mar-2004 | | Mar-2005 | | Mar-2006 | | Mar-2007 | |
|---|---|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | | | |
| Deposits | 43,486 | (64.1) | 44,316 | (61.7) | 45,405 | (59.4) | 48,560 | (56.6) |
| Borrowings | 12,457 | (18.4) | 14,608 | (20.3) | 16,989 | (22.2) | 22,256 | (26.0) |
| **Assets** | | | | | | | | |
| Loans | 35,105 | (51.7) | 37,346 | (52.0) | 39,684 | (51.9) | 47,354 | (55.2) |
| Investments | 22,187 | (32.7) | 23,289 | (32.4) | 27,694 | (36.2) | 24,140 | (28.2) |
| **Total Assets** | **67,838** | | **71,806** | | **76,481** | | **85,756** | |

Figures in parentheses as percentage of total assets/liabilities.
**Source :** RBI

The growth rate of DCCBs has been similar, with CAGR of 8.13 per cent for the period March 2004 to March 2007 (Table 3.18).

**Table 3.18: District Central Co-operative Banks – Liabilities and Assets**

(Rs. crore)

| | March 2004 | | March 2005 | | March 2006 | | March 2007 | |
|---|---|---|---|---|---|---|---|---|
| **Liabilities** | | | | | | | | |
| Deposits | 79,153 | (63.0) | 82,098 | (61.6) | 87,532 | (61.2) | 94,529 | (59.5) |
| Borrowings | 20,256 | (16.1) | 22,568 | (16.9) | 24,217 | (16.9) | 29,912 | (18.8) |
| **Assets** | | | | | | | | |
| Loans | 67,152 | (53.4) | 73,091 | (54.8) | 79,202 | (55.3) | 89,038 | (56.0) |
| Investments | 35,180 | (28.0) | 35,830 | (26.9) | 36,628 | (25.6) | 41,006 | (25.8) |
| **Total Assets** | **1,25,685** | | **1,33,331** | | **1,43,090** | | **1,58,894** | |

Figures in parentheses as percentage of total assets/liabilities.
**Source :** RBI

*Asset quality*

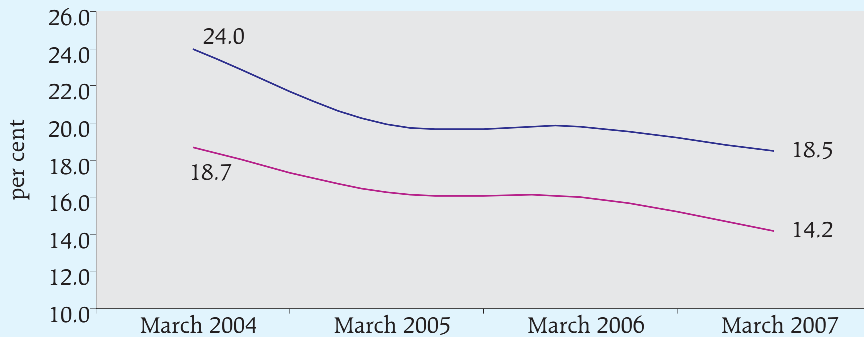
The ratio of non-performing loans to total loans is very high in the case of rural co-operatives. This is a fall-out of inadequate recovery performance, which remains a matter of concern. The asset quality of the StCBs and DCCBs is depicted in the graph below (Chart 3.33).

About 26 per cent of DCCBs and 13 per cent of StCBs were unprofitable in 2006-07.

*Earnings and Profitability*

Notwithstanding their extended reach in terms of numbers and mobilised deposits, the profitability of the sector remains low (Chart 3.34). About 26 per cent of DCCBs and 13 per cent of StCBs were unprofitable in 2006-07. The total accumulated losses of StCBs and DCCBs amounted to Rs.6,101 crore as at end-March, 2007.

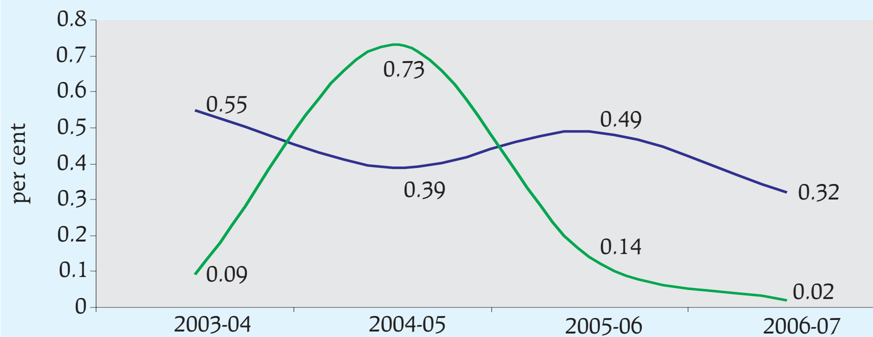
**Chart 3.33: Non-performing Loans to Total Loans - Rural Co-operatives**




**Source:** RBI.

StCBs DCCBs

**Chart 3.34: Net Profit to Total Assets – Rural Co-operatives**




StCBs DCCBs

**Source:** RBI.

One of the problems that rural co-operatives face is the cost of funds, which was above 5 per cent as at end-2007, whereas that for commercial banks during the same period was 4.8 per cent (Table 3.19).

**Table 3.19: Cost of Funds of Rural Financial Institutions – March 2007**

| Institution | Deposits + Borrowings | Cost of funds |
|---|---|---|
| StCBs | 82.6 | 5.2 |
| DCCBs | 78.3 | 5.4 |
| Commercial banks | 85.0 | 4.8 |

Deposits + borrowings and loans are as percentages to total assets of the concerned institution

Cost of funds= Interest expended/(Deposits+ Borrowings), expressed in percentage terms

**Source:** Computed from RBI data.

### 3.3.32 Issues and Concerns

Based on the assessment (the details of which are furnished in Annex-Section II), wherever the adherence is not complaint or materially non-compliant, the Advisory Panel on Financial Regulation and Supervision has made appropriate recommendations. The recommendations of the Advisory

Panel on Financial Regulation and Supervision and the views of the CFSA are summarised below:

*Risk Management*

The Reserve Bank/NABARD has not issued guidelines on risk management to StCBs/DCCBs along the lines of commercial banks. There are no guidelines on market risk, liquidity risk, operational risk or interest rate risk in banking book. The Panel recommended that once the concept of risk-based capital adequacy is introduced for StCBs/DCCBs, the issuance of guidelines on risk management along the lines of UCBs should be considered. It also recommends that some basic guidelines be stipulated regarding management of market risk, operational risk and liquidity risk. Given the stage of development of these institutions, there are no requirements for stipulation of capital charge for market risk, liquidity risk and operational risk. It is also premature to consider measurement and capital augmentation to mitigate interest rate risk in banking book.

*Abuse of Financial Services*

While the Reserve Bank has issued detailed guidelines on Know Your Customer (KYC) to StCBs and DCCBs, there are no guidelines in place which protect bank staff who report suspicious activity, either internally or directly, to the relevant authority. In the view of the Panel, this needs to be considered.

**3.3.4 Regional Rural Banks**

The RRBs are jointly owned by the Central Government, State Government and the parent commercial bank. The number of RRBs has come down from 196 as on March 31, 2005 to 133 as on March 31, 2006 and stood at 91 on March 31, 2008, consequent to implementation of the amalgamation policy. The RRBs appear to present minimal systemic risk, owing to their small size (1.7 per cent of the assets of financial institutions as at end-March 2008). Efforts are on to improve their management information system by computerizing RRB branches.

RRBs appear to present minimal systemic risk, owing to their small size.

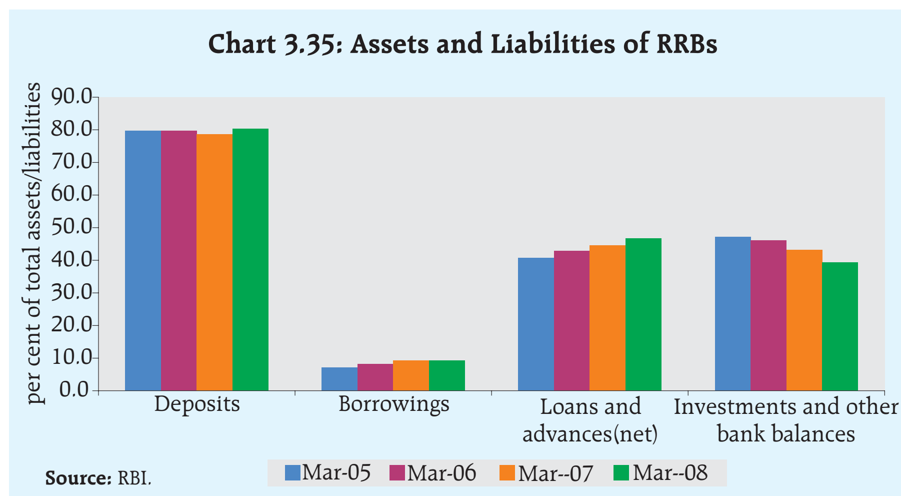
**3.3.41 Performance**

*Business Size*

The RRB sector witnessed a compounded annual growth of 16.6 per cent between 2004-05 and 2007-08. While deposits accounted for nearly 80 per cent of the funding source, the asset deployment was shared almost equally

between loans and investments[50]. There has been an improvement in the performance of RRBs consequent to the amalgamation of various RRBs (Chart 3.35).

**Chart 3.35: Assets and Liabilities of RRBs**

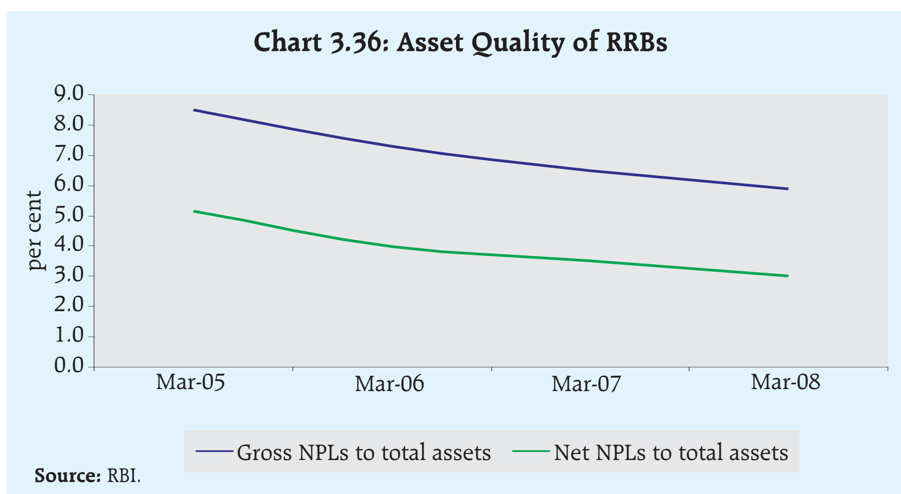



**Source:** RBI.

*Asset Quality*

The asset quality of RRBs has shown improvement, with gross NPL accounting for 5.9 per cent of total assets as on March 31, 2008. Net NPLs also declined to 3.0 per cent by end-March 2008. The ratio of recovery to demand has hovered around 80 per cent over the past few years (Chart 3.36).

**Chart 3.36: Asset Quality of RRBs**



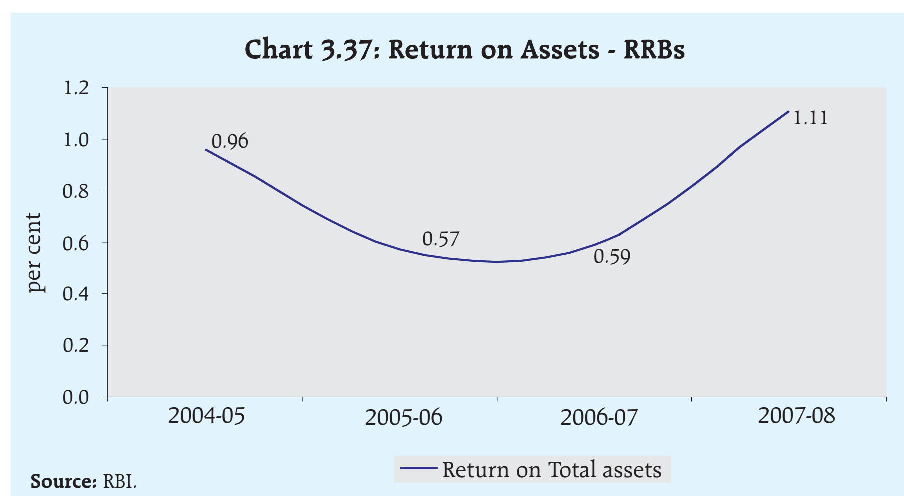

**Source:** RBI.

*Earnings and Profitability*

Consequent to the amalgamation of RRBs, the number of profit-making RRBs increased from 81 as on March 31, 2007 to 82 as on March 31, 2008 and loss making RRBs declined from 15 as on March 31, 2007 to 8 as on March 31, 2008 This has resulted in a healthy return on total assets for 2007-08 (Chart 3.37). The accumulated losses of RRBs as a per cent of total assets have come down from 4.7 during 2001-02 to 2.1 during 2007-08. Further, the

RRBs have shown improvement in key financial parameters

[50] Investments - bank balances and other investments




**Source:** RBI.

process of recapitalisation is expected to wipe out the accumulated losses of most of the RRBs that have accumulated losses.

### 3.3.42 Issues and Concerns

Based on the assessment of Basel Core Principles (the details of which are furnished in Annex-Section III), wherever the adherence is not compliant or materially non-compliant the Advisory Panel on Financial Regulation and Supervision made appropriate recommendations which are summarised below:

*Risk Management*

The existing risk management guidelines issued to RRBs broadly cover only the credit and liquidity risks. However, given the limited and rudimentary scale of operations of RRBs, there is no need to prescribe capital charge for market risk and operational risk for some time. Sophisticated techniques like internal risk assessment models and integrated risk management are not considered necessary at this stage in view of the size and volume of RRBs and the nature of their business operations.

There is no need to prescribe capital charge for market risk and operational risk for RRBs and rural co-operatives.

*Market Risk*

No guidelines have been prescribed for assessing market risk by the RRBs. The RRBs follow a methodology for assessing their liquidity position, but not on an Asset Liability Management (ALM) basis. ALM has been introduced in 12 RRBs with effect from April 1, 2007. NABARD has been examining these aspects during the course of on-site inspections. Given the fact that RRBs are currently in a non-Basel regime, the assessment of market

risk can be implemented only after CRAR is introduced. This is envisaged along with the consolidation and recapitalisation of RRBs. As commercial banks are stakeholders in RRBs, guidelines on operational risk along the lines applicable to commercial banks can be issued to RRBs. As regards liquidity risk, the concept of Asset Liability Management can be introduced to all RRBs along the lines of the one introduced to commercial banks. However, stipulating capital charge for such risks will be premature at this stage.

*Interest Rate risk in Banking Book*

No guidelines on interest rate risk in banking book have been issued to RRBs. Since the RRBs are yet to migrate to Basel I mode, the introduction of interest rate risk in banking would mean placing a significant burden on these entities, and this may not be considered for these entities at least over the medium term.

*Large Exposure Limits*

NABARD does not obtain information regularly that enables it to review the concentrations, including sectoral and geographical exposures, within a bank's portfolio. The Panel observed that most of the lendings by the RRBs are under the priority sector segment and they have very limited exposure to other segments, both under lending and investments. Moreover, these exposures are reviewed at the time of on-site inspections with a broad-based approach to ascertain the sectoral and segment-wise credit disbursed by the banks. Hence, the Panel does not recommend calling for sectoral and geographical exposures from RRBs at present.

*Internal control*

While NABARD has issued guidelines regarding the separation of functions in respect of the back office and front office, it does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination. NABARD may comment on this aspect during the on-site examination of RRBs.

*Abuse of Financial Services*

The KYC guidelines to RRBs do not have elements like a customer acceptance policy, customer identification, verification and due diligence programme; policies and processes to monitor and recognise unusual or potentially suspicious transactions, particularly of high-risk accounts; escalation to senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; or clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Given the size of their operations and fact that the clientele of RRBs mainly comprise those under relaxed Know Your Customer norms, they may continue with the existing practice, and rigorous supervision may not be necessary. However,

Rural co-operative and RRBs are yet to put in place measures to prevent money laundering.

once their operations grow in volume and coverage, detailed guidelines along the lines of the ones issued to commercial banks, like customer acceptance policy and customer identification policy, could be considered.

NABARD does not determine whether these banks have enhanced due diligence policies and processes regarding correspondent banking. Due diligence policies and processes regarding correspondent banking are yet to be put in place as correspondent banking is in a nascent stage in RRBs. Once these banks enter into full-fledged correspondent banking, guidelines on due diligence policies could be considered.

The RRBs are yet to put in place measures for preventing, identifying and reporting of potential abuse of financial services, including money laundering. Guidelines should be issued advising RRBs to put in place measures for preventing, identifying and reporting of potential abuse of financial services, including money laundering.

NABARD should issue guidelines whereby staff who report suspicious activity are not held liable by the relevant authority.

NABARD does not determine whether the RRBs have clear policies and processes for the staff to report problems related to the abuse of the banks' financial services, either to local management or to the relevant dedicated officer or to both. There are also no laws and regulations which ensure that a member of a bank's staff who reports suspicious activity in good faith, either internally or directly, to the relevant authority cannot be held liable. NABARD should determine during on-site examination that the banks have policies and processes, whereby staff can report any problems relating to abuse of banks' financial services to either local management or relevant dedicated officer or to both. Further, NABARD should, in consultation with the Reserve Bank, issue guidelines whereby staff who report suspicious activity are not held liable by the relevant authority.

*Accounting and Disclosure*

All RRBs should be required to publish their balance sheets from March 2009.

The RRBs had been granted exemption till March 31, 2008 from the provisions of Section 31 of the Banking Regulation Act, 1949 relating to publication of their balance sheets and profit & loss accounts, together with the auditors' reports. However, RRBs have been advised to display the balance sheet and profit & loss account in all their branches. NABARD may consider doing away with the exemption from year ending March 31, 2009 and require RRBs to publish the balance sheet and profit & loss account, together with the auditors' reports.

The CFSA is of the view that all these recommendations should be considered by the Reserve Bank and, where necessary, in consultation with the Government.

### 3.3.5 Summary

The size of the co-operative and the rural financial sector in India remains small compared to commercial banks. The financial performance of the co-operative sector is less than satisfactory in certain aspects. The important observations and recommendations of the Panel in regard to rural co-operatives, urban co-operative banks, and RRBs are listed below:

#### 3.3.51 Broader Issues

The prevalence of dual control in the rural financial and co-operative sectors affects the quality of supervision and regulation between the Reserve Bank/NABARD and the Government. While MoUs have been entered into, further issues of regulatory co-operation could be structured therein, particularly in critical areas related to governance and management issues. There could be a re-look at the uniform format of MoUs and, if needed, the format could be differentiated in the case of individual State Governments/ Central Government to fine tune it, with selective deviations suiting the requirements of individual states/institutions, without diluting the sound principles of the uniform format.

In the case of the rural banking sector, control is three-way as banking regulation is vested with the Reserve Bank, while supervisory responsibilities lie with NABARD. NABARD has limited supervisory powers. There is a view that the present arrangement wherein NABARD as well as the Reserve Bank both have well-defined roles in terms of the RBI Act, 1934 and RRBs Act, 1976 and the same need not be disturbed for now. The CFSA, however, feels that this issue needs to be addressed from the angles of conflict of interest, cost and supervisory efficiency, and a considered view needs to be taken by the Reserve Bank. The aspect relating to supervision of RRBs was examined earlier by the Government and it was decided that the present arrangement of monitoring of RRBs by the Reserve Bank and NABARD would continue. However, the CFSA feels that the role of NABARD as a DFI and regulator/ supervisor of rural financial institutions may be considered to be segregated appropriately, so that NABARD will function exclusively as a specialised DFI. Rural co-operatives should be regulated and supervised by a separate regulatory authority formed exclusively for the purpose. As regards the supervision of RRBs the CFSA feels that the recommendation of the Sardesai Committee can be considered.

Since only borrowers are their members, there is the possibility of impairment in corporate governance and management needs of co-operatives, as there is a tendency for these entities to pursue borrower-oriented policies. Also, the appointment of directors is based on political affiliations rather than on merit. There is a requirement to encourage membership of depositors on

par with borrowers, and reduce political interference to improve the functioning of these entities. Powers regarding the appointment of auditors, simplification of the tiered structures of rural co-operatives to reduce costs, and bringing aspects related to management of co-operative banks within the ambit of the BR Act could be considered. To introduce greater professionalism and as a best practices guide for corporate governance, following the best governance principles as enunciated by the World Council of Credit Unions should be considered.

A duration-based capital charge for market risk for scheduled and larger UCBs could be introduced. Risk-based capital requirement for rural financial institutions could be introduced in a phased manner. There is a need to draw up a roadmap to ensure that only licensed banks operate in the co-operative space.

**3.3.52 Urban Co-operative Banks**

There has been improvement in the performance of UCBs, which have been growing at 10 per cent annually. The number of financially stronger UCBs has been increasing between 2004-05 and 2007-08. Deposits have been their dominant funding source. Though their average CRAR has been declining, it is above the regulatory minimum. Though NPAs are high as compared to commercial banks, they have shown improvement. Consolidation in the sector in a non-disruptive manner could bring about harmony in the prudential norms. The stress tests conducted on the credit portfolio for scheduled UCBs show that the resilience of the sector to adverse movements in credit quality is not very strong. The assessment of Basel Core Principles, wherever applicable, reveals gaps in areas of risk management and internal control.

**3.3.53 Rural Co-operatives**

The rural co-operatives have a two or three-tier structure, with some states having a unitary structure for state-level banks operating through their own branches, and others presenting a mixed picture that incorporates both unitary and federal structures. Like the urban co-operative sector, this sector is also subject to dual regulatory control. The regulatory powers are vested with the Reserve Bank and the Registrar of Co-operative Societies (RCS).The supervisory power is vested with NABARD and these institutions are not within the supervisory oversight of Board for Financial Supervision (BFS)

constituted by the Reserve Bank. There is however a Board of Supervision constituted independently by NABARD, which is kept abreast of the supervisory concerns that emanate from the functioning of rural co-operatives and other rural financial institutions. The sector is faced with low resource bases, inadequate business diversification and recoveries, high levels of accumulated losses, weak MIS and poor internal controls. The ratio of NPLs continues to be high in case of these entities. The assessment of BCPs reveals gaps in areas of prudential requirements and risk management.

**3.3.54 Regional Rural Banks**

There has been improvement in the performance of RRBs consequent to the amalgamation of various RRBs as their numbers have come down from 196 as on March 31, 2005 to 91 as on March 31, 2008. There has been an improvement in asset quality and profitability of RRBs.

Due to the policy of amalgamation that is being pursued from 2005-06 onwards, the number of RRBs is decreasing. The sector has registered good growth over March 2004 and March 2008. The assessment of Basel Core Principles, wherever applicable, suggests gaps in risk management, internal control and abuse of financial services.

In the interest of improving corporate governance in RRBs, it would be desirable to make nominated directors to RRB Boards accountable. Over the medium term, the Government could consider independent nominees on the boards of these banks. In this context, however, the Government feels that the RRB Boards take collective decisions and each director whether nominated or otherwise are equally responsible for decisions.

## 3.4 Non-Banking Financial Companies

Internationally, the range of non-banking financial institutions (NBFIs), which are also categorised as other financial intermediaries (OFIs), includes among other things pension funds, securities dealers, investment funds, finance, leasing and factoring companies and asset management companies. While such institutions are subject to a prudential regulatory regime in India and they remain financially sound, the recent global financial turmoil has brought to the fore the role such entities played in impacting systemic stability. Financial Development India, 2008 (World Economic Forum) ranked non-banks in India at 16 against the country's overall rating of 31 (out of 52 countries).

NBFIs have become important since they can impact systemic stability.

Being sometimes dubbed a 'shadow banking system', the activities of OFIs include SIVs, conduits, money market funds, monolines, investment banking, hedge funds and other non-banking financial services. These OFIs were typically bank subsidiaries or associates which took advantage of regulatory gaps between jurisdictions and invested in illiquid long-term assets, like sub-prime mortgages and other similar vehicles, by funding them through short-term instruments, like commercial papers, making them

susceptible to credit risk, market risk and, more particularly, to liquidity risk. As they were not depository institutions, these entities were perceived not to have direct or indirect access to the central bank's lender of last resort support. Thus, under the conditions of market illiquidity, they could go bankrupt if unable to refinance their short-term liabilities. The sub-prime turmoil resulted in a widespread liquidity crunch in short-term fund (*e.g.*, CP) markets. As a result, a significant portion of the shadow banking system was not able to fund their asset base. Given the contagion of such entities with the parent banks, the bankruptcy of such entities aggravated systemic instability by transforming the sub-prime mortgage risk into a global liquidity and credit crunch. Given the systemic impact of the crisis in the USA, the Federal Reserve Bank has extended lender of last resort to some of the OFIs by invoking Clause 14 of the Federal Reserve Act[51].

In India, there are two broad categories of Non-Banking Financial Companies (NBFCs), *viz.*, Non-Banking Financial Company – Deposit Taking (NBFC-D) and Non-Banking Financial Company – Non-Deposit Taking (NBFC-ND). NBFC-ND has been further granulated to NBFC-ND and NBFC-ND-SI[52], *i.e.*, those that have an asset size of more than Rs.100 crore. Residuary Non-Banking Financial Company (RNBC) is another type of NBFC that accepts deposits; RNBCs[53] formed the dominant deposit accepting companies, holding nearly 90 per cent of the deposits (Table 3.20). As the business models of the deposit taking and the non-deposit taking entities vary significantly, the analysis of performance has been presented separately for the deposit taking and the non-deposit taking groups of NBFCs. While Housing Finance Companies (HFCs) are also part of the broader NBFCs group, in view of the differences in regulatory structure for this sector, HFCs are covered in a separate section.

[51] These companies have been brought into the regulatory fold because of their inter-linkages with money markets, equity markets, debt markets, banks and financial institutions. They pose systemic risk.

[52] Section 14. Open Market Operations: Purchase and Sale of Cable Transfers, Bank Acceptances and Bills of Exchange: Any Federal Reserve Bank may, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, purchase and sell in the open market, at home or abroad, either from or to domestic or foreign banks, firms, corporations, or individuals, cable transfers and bankers' acceptances and bills of exchange of the kinds and maturities by this Act made eligible for rediscount, with or without the endorsement of a member bank.

[53] In the sector, the business model of the RNBC was found to be non-viable and, therefore, the companies were advised to migrate to other business models. Of the three RNBCs, one company has already converted to NBFC-ND. The other two are in the process of exiting this model of business by repaying their liabilities by 2015.

| Table 3.20: Profile of NBFC-D/RNBC Segment | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (Rs. crore) | | | | | | | | |
| Institution | Non-Banking Financial Companies – Deposit Taking | | | | Residual Non-banking Companies | | | |
| | 2004-05* | 2005-06 | 2006-07 | 2007-08 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| Reporting companies (No.) | 703 | 435 | 362 | 335 | 3 | 3 | 3 | 2 |
| NoF | 5,036 | 6,494 | 6,921 | 10,547 | 1,065 | 1,183 | 1,366 | 1,714 |
| Public deposits | 3,926 | 2,447 | 2,077 | 2,037 | 16,600 | 20,175 | 22,622 | 22,358 |
| Borrowings | 22,245 | 24,942 | 32,452 | 50,384 | Nil | Nil | Nil | Nil |
| **Total Assets** | **36,003** | **37,828** | **48,553** | **70,292** | **19,057** | **21,891** | **23,172** | **24,452** |

NoF: Net owned funds

* : Data for 2004-05 includes Mutual Benefit Companies (MBCs), Mutual Benefit Finance Companies (MBFCs) and Miscellaneous Non-Banking Companies (MNBCs) besides Non-Banking Financial Companies – Deposit Taking (NBFCs-D), hence not comparable to the data for the years 2005-06 and 2006-07.

**Source :** RBI

While NBFCs-D have been regulated by the Reserve Bank from 1963, an amendment to the RBI Act in 1997 empowered the Reserve Bank to regulate and supervise all categories of NBFCs more comprehensively. NBFCs-ND, until recently, were subject to minimal regulation as they were non-deposit taking. Recognising, however, the growing importance of this segment and their linkages to banks and other financial institutions, capital adequacy and exposure norms were made applicable to NBFCs-ND-SI (assets above Rs.100 crore) from April 1, 2007.

The Reserve Bank as part of the way forward considering whether entities other than banks should be allowed to take deposits and whether holding companies could be firmly brought under the regulatory purview of the Reserve Bank.

Internationally, there have been various approaches to regulation of NBFCs. In some cases, like India, regulation is in the hands of the central banks, while it is with other institutions in some other countries. There are also instances where the regulation of deposit-taking NBFIs is vested with the central bank, but the non-deposit taking OFIs are under other regulatory institutions, like the securities market regulator. A cross-country approach to the regulation of NBFCs is furnished in Table 3.21.

### 3.4.1 Performance

#### 3.4.11 NBFCs-D

*Business Size:* Between March 2006 and March 2008 there has been a decline in the public deposit base of NBFCs-D by 17 per cent. However the share of public deposits to total assets declined from 6.4 per cent to 2.9 per cent for these institutions. Simultaneously, borrowings have emerged as the main funding source, accounting for more than 70 per cent of the funding requirements as at end-March 2008 (see Table 3.20).

There is increased borrowing by NBFCs-D.

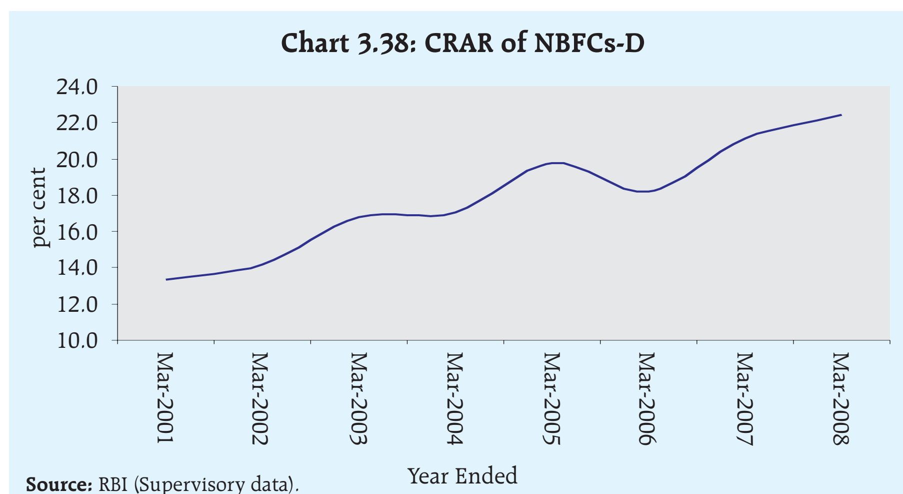
| Table 3.21: Cross-country Experience of Regulating NBFCs | | |
|---|---|---|
| **Country** | **Regulatory Agency** | **Regulated Entities** |
| Australia | Australian Financial Institution Commission and State Supervisory Authority (SSA) | Building Societies Credit Union Special Service Providers |
| | Australian Securities Commission | Other non-banks |
| France | The Banking Regulating Committee | Specialised FIs and companies<br>(a) Consumer Credit<br>(b) Investment Credit<br>(c) Real Estate Financing<br>(d) Equipment Leasing<br>(e) Real Estate Leasing<br>(f) Factoring<br>(g) Constitution of Surety |
| | | NBFIs |
| Hong Kong | Hong Kong Monetary Authority | Deposit Taking Companies |
| | | NBFIs |
| Malaysia | Bank Negara Malaysia | (a) Finance Companies<br>(b) Merchant Banks |
| | Government Departments and Agencies | NBFIs<br>(a) Development Finance Institutions<br>(b) Provident and Pension Fund<br>(c) Savings Institutions<br>(d) Insurance Companies<br>(e) Other Financial Institutions |
| | Malaysian Securities Commission | Unit trusts |
| Korea | Ministry of Finance and Economy | NBFIs |
| Singapore | Monetary Authority of Singapore | NBFIs<br>(a) Merchant Banks<br>(b) Finance Companies<br>(c) Securities and Financial Futures Firm<br>(d) Money Changers and Remitters<br>(e) Insurance Companies |
| Thailand | Thai Securities and Exchange Commission | Securities firms and mutual funds |
| Philippines | Central Bank | Universal banks and commercial banks dealing in Government securities as well as the activities of primary dealers |
| | Securities and Exchange Commission | Securities broker-dealers and investment companies |

**Source**: RBI.

*Financial Soundness*

The capital adequacy ratio of NBFCs-D (including RNBCs) has been well over the regulatory minimum of 12 per cent and is showing an increasing trend (Chart 3.38). As at end-March 2008, 44 NBFCs out of 320 had CRAR ratios less than the stipulated minimum of 12 per cent, as against 20 out of 374 in the previous year.

**Chart 3.38: CRAR of NBFCs-D**

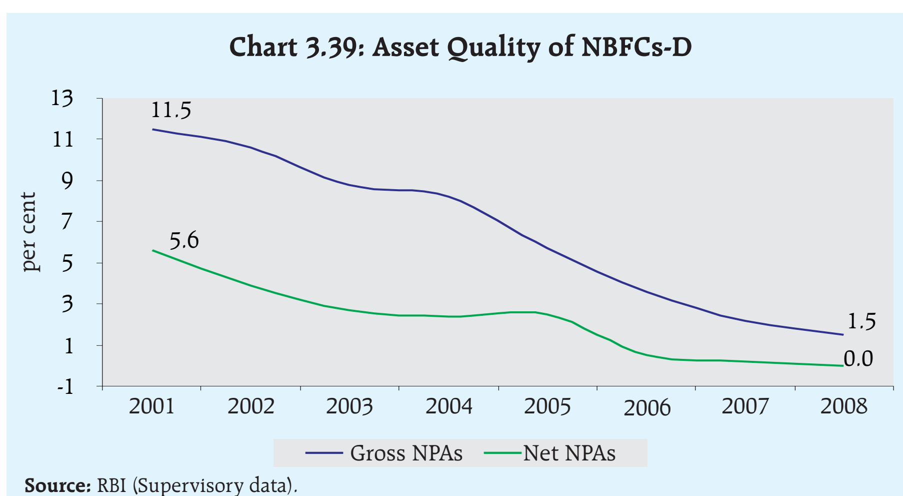



**Source:** RBI (Supervisory data).

*Asset Quality*

The asset quality of NBFCs-D reveals a significant improvement inasmuch as their gross NPL to gross loans ratio has declined from March 2001; the overall ratio was 1.5 per cent at end-March 2008 (Chart 3.39).

**Chart 3.39: Asset Quality of NBFCs-D**




**Source:** RBI (Supervisory data).

*Earnings and Profitability*

The financial performance of NBFCs-D reveals that their income grew by 79.3 per cent as against 45.4 per cent growth in expenses during the year 2007-08. The net profit had increased from Rs. 504 crore during 2006-07 to Rs. 2009 crore during 2007-08 (Table 3.22).

| Table 3.22: Key Financial Indicators of NBFC-D | | | |
|---|---|---|---|
| | | | (Rs. crore) |
| | **2005-06** | **2006-07** | **2007-08** |
| Income | 4599 | 5721 | 10255 |
| Expenses | 3753 | 4831 | 7023 |
| Operating profit | 847 | 890 | 3232 |
| Net profit | 556 | 504 | 2009 |

**Source:** RBI.

The net profit to total assets ratio for the NBFCs-D sector has remained above 1 per cent in recent years and has been showing an increasing trend. The cost-income ratio of this sector has declined during 2007-08 as compared to earlier years (Table 3.23).

| Table 3.23: Key Performance Indicators of NBFC-D | | | |
|---|---|---|---|
| | | | (per cent) |
| | **2005-06** | **2006-07** | **2007-08** |
| Income/Total Assets | 12.2 | 11.8 | 14.6 |
| Expenditure/Total Assets | 9.9 | 9.9 | 10.0 |
| Net Profit/Total Assets | 1.5 | 1.0 | 2.9 |
| Cost-Income Ratio | 81.6 | 84.4 | 68.5 |

**Source:** RBI.

### 3.4.12 NBFCs-ND-SI

*Business Size*

With a view to protecting the interests of depositors, NBFCs-D were subject to prudential regulation on various aspects of their functioning from 1963 onwards. However, non-deposit taking NBFCs (NBFCs-ND) were subject to minimal regulation. In light of the evolution and integration of the financial sector, it was felt that all systemically relevant entities offering financial services ought to be brought under a suitable regulatory framework to contain systemic risk (Table 3.24). Therefore, as a first step, all NBFCs-ND with an asset size of Rs.100 crore and more as per the last audited balance sheet were considered as Systemically Important NBFC-ND (NBFC-ND-SI) and a specific regulatory framework involving prescription of capital adequacy and exposure norms was put in place from April 01, 2007 for these entities. Consequent to a review of the experience with the regulatory framework since April 2007, the capital adequacy requirement of NBFCs-ND-SI has been raised to 12 per cent by March 31, 2009 and further to 15 per cent CRAR by

**Table 3.24: Profile of Systemically Important Non-Deposit Taking NBFCs**

| Source of funds | March 2006 (Rs crore) | March 2007 Rs crore) | March 2008 (Rs. crore) |
|---|---|---|---|
| Secured borrowings | 71,509 | 93,765 | 1,21,082 |
| *of which:* Debentures | 39,179 | 32,564 | 44,439 |
| Loans from Banks | 16,116 | 19,503 | 25,774 |
| Unsecured borrowings | 1,03,086 | 1,18,221 | 1,50,206 |
| *of which:* Loans from banks | 28,276 | 33,191 | 46,243 |
| Inter-corporate deposits | 19,459 | 20,018 | 22,019 |
| Debentures | 20,788 | 30,549 | 44,432 |
| **Use of funds** | | | |
| Total loans | 1,68,728 | 2,12,667 | 2,78,632 |
| *of which:* Secured loans | 63,120 | 1,14,898 | 1,60,017 |
| Unsecured loans | 82,996 | 69,609 | 88,783 |
| Capital market exposure | 59,583 | 81,435 | 1,11,630 |
| **Total Asset/Liabilities** | **2,50,765** | **3,17,898** | **4,08,705** |
| As a per cent of total assets/liabilities of SCB | 9.00 | 9.20 | 9.40 |

**Source:** RBI

March 31, 2010. They have been asked to make disclosures in their balance sheet in respect of CRAR, maturity pattern of assets and liabilities and exposure to the real estate sector from March 31, 2009. They are also required to furnish statements of short-term dynamic liquidity on a monthly basis and statements of structural liquidity and interest rate sensitivity on a half-yearly basis.

NBFCs-ND-SI is the fastest growing segment of NBFCs growing at a compound rate of 28 per cent between March 2006 and March 2008. A profile of their balance sheet and income position reveals that, in aggregate, NBFCs-ND-SI had an exposure to the capital market of 31 per cent as of March 2008. Though the Capital Market Exposure (CME) as a percentage of total assets appears to be high, it is restricted to investment companies. The banks' exposure in investment companies at Rs.18,800 crore at the end of March 2008 constituted 37.4 per cent of the CME of investment companies at Rs.50,300 crore at that time. On the other side, bank exposure constituted only 35.6 per cent of the borrowings of the investment NBFC-ND-SI at end-March 2008. It is, therefore, likely that the CME of investment companies is dependent on other sources of borrowings rather than bank exposures.

From the sources of funds at end-March 2008, it is observed that unsecured borrowings constitute the major portion (36.8 per cent) of sources of funds (total liabilities) and 55.4 per cent of the total borrowings of NBFCs-ND-SI which, other than cost implications, could also have a systemic impact. Debentures accounted for around 33 per cent of the total borrowings, half of which is unsecured. While bank borrowings (secured as well as unsecured) constituted 27 per cent of the total borrowings of NBFCs-ND-SI as on the same date, a significant portion (17 per cent) is unsecured. In order to reduce any systemic instability arising out of exposures to unsecured borrowings from NBFCs, there is a requirement for access to alternate sources of funds by NBFCs.

*Asset Quality*

Asset quality improved between 2006 and 2008. As at end-March 2006, gross NPAs to total credit exposure stood at 7.0 per cent, which declined to 3.1 per cent by end-March 2008. Similarly, the ratio of Net NPA to total credit exposure declined from 3.2 per cent to 2.0 per cent between March 2006 and March 2008.

*Earnings and Profitability*

The financial performance of NBFCs-ND-SI[54] reveals that income grew by 26 per cent as against the growth in expenses of 33 per cent during 2007-08.

Financial performance indicators show that there has been a marginal decline in net profits to total assets, from 2.3 per cent in 2006-07 to 2.1 per cent in 2007-08 (Table 3.25).

**Table 3.25: Key Financial Indicators of NBFC-ND-SI**

(Rs. crore)

| | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|
| Income | 18342 | 31281 | 39537 |
| Expenses | 11874 | 20552 | 27291 |
| Net profit | 4301 | 7460 | 8705 |
| Net profit/Total assets (per cent) | 1.7 | 2.3 | 2.1 |

**Source:** RBI.

### 3.4.13 Issues and Concerns

The CFSA notes that although banks dominate the Indian financial spectrum, NBFCs play an important role in financial markets. With their unique strengths, the stronger NBFCs could complement banks as innovators and partners. At the same time it notes that the entry of commercial banks has completely altered the dynamics of retail financing, and the proportion of NBFCs' disbursement in retail assets has declined over time. NBFCs – particularly the non-deposit taking ones – have been looking into high-yield segments, such as personal loans of small-ticket sizes, home equity, loans against shares and public issue financing to boost their bottom lines. The core strength of NBFCs lies in their strong customer relationships, good understanding of regional dynamics, service orientation and ability to reach out to customers who would otherwise be ignored by the banks, which makes such entities effective conduits of financial inclusion.

The entry of commercial banks has completely altered the dynamics of retail financing.

[54] Since the concept of NBFC-ND-SI was only introduced in December 2006, comparison figures only relate from the period 2005-6 onwards.

Given the importance of NBFCs in the financial landscape, the CFSA feels that the following issues require to be addressed:

*Source of Funds*

An important factor affecting the growth of NBFCs is their funding requirements. Unlike banks, NBFCs, particularly the stand-alone ones, do not have access to low-cost deposits[55]. At the same time, as these entities are perceived to invest more in sensitive assets, there has been a tightening of norms by the Reserve Bank in areas like bank lending to NBFCs, bank exposure limits, higher provisioning requirements and higher risk weights, regardless of the credit rating of the borrowing NBFC (the current prudential norm regarding NBFC). These measures have reduced NBFCs' access to bank funds and also increased their cost of funds. The Panel on Financial Stability Assessment and Stress Testing observed that restrictions on the range of activities that NBFCs can undertake might not be the appropriate remedy, as they cannot be compared with banks. In the case of banks, there are limited restrictions on their liability side as they can raise low-cost deposits. On the asset side, there are restrictions on their lending and investments. Therefore, if a level playing field is sought to be ensured between banks and NBFCs by restricting NBFCs on their asset side akin to those for banks, the Panel felt that a similar freedom needs to be provided to them on their liability side as well. Contextually, the Panel also argued for the development of an active corporate bond market to address the funding needs of these entities.

The CFSA observes that there appears to be a significant convergence between deposit taking and non-deposit taking NBFCs as regards the source of funds. Both sectors are increasingly dependent on borrowings, which account for about two-thirds of their funding requirements. In addition to the lack of access to low-cost funds, deposit taking NBFCs also bear high regulatory costs in the form of prescribed liquidity stipulations[56] and additional reporting requirements. The CFSA believes that a level playing field between banks and NBFCs may not be practical and that, over the medium term, it may in fact become increasingly difficult for deposit taking NBFCs to compete with banks, causing these entities to become unviable or be merged with banks. In this context, the Reserve Bank has given an option to the NBFCs to voluntarily move out of public deposits acceptance activity.

Non-deposit taking NBFCs are growing rapidly and unsecured borrowings comprise their single largest source of funds (over 36 per cent), which includes a significant amount of borrowings from banks/FIs. Thus, they have a systemic linkage and need to be monitored closely to ensure that they do not pose any risk to the system and also to ensure that regulations do not stifle their growth. In this context, both the direct and indirect exposure

A level playing field between NBFCs and banks is not practical.

[55] Some NBFCs have either gone into partnerships with banks or metamorphosed into banks, in order to access low-cost deposits and boost their bottom lines.

[56] NBFC-Ds are required to maintain 15 per cent of their total public deposits in approved securities.

to depositors needs to be taken into account. To the extent that they rely on bank financing, there is an indirect exposure for depositors. On the one hand, the concentration of funding has risks and, on the other, the caps on bank lending to NBFCs will constrain their growth. The problem has been further aggravated due to the difficult liquidity situation where NBFCs seem to be facing.

The CFSA agrees with the suggestion given by the Panel on Financial Stability Assessment and Stress Testing that, rather than putting a cap on bank lending to NBFCs, there is an urgency to develop a corporate debt market and other alternative financing sources – both in terms of growth and risk diversification considerations[57].

*Regulatory framework for monitoring different types of NBFCs*

Given the increasing competition faced by NBFCs from banks in the retail sector, there has been a decline in their share of lending to areas like car and commercial vehicle financing[58]. This is mainly due to the fact that banks have an inherent advantage over NBFCs in terms of access to low-cost funds. This has started putting pressure on the profitability of the deposit taking NBFC sector as they are not able to pass on the increase in their cost of funds to ultimate borrowers. This has seen them diversifying into riskier areas, like small-ticket personal loans. It has resulted in a mismatch between the demand for loans and supply of credit from organised financiers, enabling players (loan companies) to garner significantly higher rates of return. A significant segment of NBFCs-ND, *i.e.*, the investment companies, have adopted a capital market-based business model, with a presence in the loan against shares and public issue financing businesses on account of higher yields in these segments. The Panel on Financial Stability Assessment and Stress Testing felt that there is a need to devise an appropriate framework to regulate this diverse set of companies with different business models.

There is an urgency to develop a corporate debt market to facilitate funding of NBFCs.

The CFSA is of the view that while it may not be practical to compare the functioning of NBFCs with that of banks, there is a need to provide an environment for encouraging NBFC growth. The CFSA feels that while the regulatory principles require uniformity across entities, the feasibility of

[57] The measures needed for the development of a corporate bond market have been elaborated in detail in the section on the corporate bond market.

[58] A CRISIL Study observes that the proportion of NBFC disbursements in car financing reduced to 18 per cent in 2005-06 compared to 35 per cent in 2001-02. In the financing of commercial vehicles, the corresponding figures are 50 per cent and 86 per cent.

diverse rules for entities with different business models could be considered by the Reserve Bank. The CFSA also notes in this regard that there is separate risk-based capital adequacy ratio prescribed for rated (12 per cent) and unrated NBFCs-D (15 per cent).

*Regulatory Arbitrage*

The Panel on Financial Regulation and Supervision segregated NBFCs under the following four broad heads:

(i) Stand-alone NBFCs;

(ii) NBFCs which are subsidiaries/associates/joint ventures of banking companies;

(iii) NBFCs and banks which are under the same parent company, *i.e.*, sister concerns; and

(iv) NBFCs which are subsidiaries/associates of non-financial companies.

There appears to be no scope for regulatory arbitrage for stand-alone NBFCs. However, there is a difference in regulatory treatment inasmuch as NBFCs which are part of a banking group are subject to stricter prudential norms in their scope of activities. For example, stand-alone NBFCs could offer discretionary portfolio management schemes, which cannot be offered by NBFCs within a banking group. At the same time, it must be appreciated that, unlike stand-alone entities, NBFCs which are part of a banking group have recourse to cheaper funding sources because of the parent banks' ability to raise low-cost deposits. The Panel felt that from a prudential standpoint, the regulatory structure should duly recognise both the advantages and disadvantages of the operational environment of respective NBFCs.

The Panel observed that regulatory arbitrage in respect of NBFCs which are subsidiaries/joint ventures/associates of bank holding companies has been addressed to a significant extent through the introduction of consolidated supervision and stipulation of capital requirements for the banking group as a whole. Mandatory regulatory limits in respect of sensitive exposures (*e.g.*, capital market exposure) for the banking group as a whole have also been prescribed. Further, the financial inspection of banks carried out by the Reserve Bank does provide for a 'review' of the 'overall activities' on a group-wide basis in respect of the banking group. It should, however, be noted that sister concerns, *i.e.*, banks and NBFCs under the same parent company, would not fall within the ambit of consolidated supervision.

The feasibility of diverse rules for entities with different business models needs to be considered.

To address this gap, the regulatory authorities, *viz.*, the Reserve Bank, IRDA and SEBI are developing a process for regulation and supervision of financial conglomerates. Under the current financial conglomerate monitoring mechanism, banks which have been termed 'designated entities' submit varieties of information to the supervisory department of the Reserve Bank on group-level issues, and also in respect of individual entities of the

group. Some of the group-level information submitted to the Reserve Bank relate to intra-group transactions and exposures and capital adequacy. The CFSA concurs with the Panel's recommendation that the process of forming an appropriate structure for regulation and supervision with the apposite legislative authority, which is under progress, needs to be expedited.

**3.4.14 Assessment of Basel Core Principles**

Based on the assessment of Basel Core Principles (the details of which are furnished in Annex-Section-IV), wherever the adherence is not compliant or materially non-compliant the Advisory Panel on Financial Regulation and Supervision had made appropriate recommendations which are summarised below:

*Sharing of Information with Domestic and Foreign Regulators*

There are no formal arrangements[59] in place for co-operation and information sharing with the foreign financial sector supervisors of NBFCs. Though policy initiatives have been taken to recognise the role of co-operation between home-host regulators, no guidelines have yet been issued. The Reserve Bank could expedite issuing guidelines in this regard. The possibility of a joint agreement when RBI[60] is signing an MoU with overseas regulators may be explored.

*Transfer of Significant Ownership*

The existing guidelines do not define 'controlling interest' in respect of NBFCs. A definition of 'substantial interest' has, however, been given in the prudential guidelines. The Reserve Bank should explore the possibility of defining 'controlling interest'. Further, it should issue necessary guidelines to NBFCs, advising them to inform the Reserve Bank of any significant change in ownership.

At present, the suitability of major shareholders and senior management is not subjected to detailed scrutiny. The Reserve Bank needs to explore the option of examining the suitability of the major shareholders and senior management of NBFCs. However, when due diligence on a director of NBFCs

The possibility of signing MoUs with foreign regulators for supervision of NBFCs should be explored.

[59] At present, the Reserve Bank informally approaches the overseas regulator for their views on the entities under their jurisdiction.

[60] NBFCs are now selectively permitted to set up overseas subsidiaries/joint ventures/ representative offices. The parent Indian NBFC is required to put in place a system of periodic reporting by the subsidiary abroad to ensure that it is not a shell company and that the operations of the subsidiary abroad are not being conducted in a manner that violates other specified terms and conditions.

is done at the time of registration or change in management, the Reserve Bank can ask for a change of the director if the fit-and-proper criteria are not met. There are fit-and-proper criteria for finance companies prescribed by the Monetary Authority of Singapore and the Hong Kong Monetary Authority.

The Reserve Bank does not obtain the names and holdings of all significant shareholders or those that exert a controlling influence, including the identities of beneficial owners of shares being held by nominees. However, details of 'substantial interest' of promoters, the chairman, managing directors and CEO are a part of the Certificate of Registration application form which is obtained by the Reserve Bank. The Reserve Bank should define controlling interest obtain information on the names and holdings of significant shareholders of NBFCs who exert a controlling influence through periodic off-site returns.

*Permissible Activities*

There is no requirement to notify the Reserve Bank of any substantive changes in the activities, structure and overall condition of NBFCs or as soon as they become aware of any material adverse developments. The Reserve Bank should issue requisite guidelines in this regard.

*Major Acquisitions*

Investments by NBFCs are governed by the Prudential Norms Directions, 2007. However, the Reserve Bank has no power to review major acquisitions by an NBFC against any prescribed criteria. Establishment of cross-border operations, and corporate affiliations or structures which could expose the NBFCs to undue risks or hinder effective supervision are also not reviewed. Given the NBFCs' developmental role in promoting new companies in the form of subsidiaries/associates, they should not be constrained by any specific mandated criteria regarding acquisition. The Reserve Bank can however, consider obtaining information relating to cross-border operations and corporate affiliations as part of the off-site surveillance.

*Large Exposure Limits*

Though the Reserve Bank has defined 'group of connected counterparties' and set prudent limits on large exposures to a single counterparty or a group of connected counterparties, it has not issued any instructions to NBFCs as regards review and reporting of material concentration to the Board. There is a need to issue guidelines for establishing thresholds, depending on their respective scales of operation, and reporting exposures above this threshold to the Board. This aspect can also be verified by the Reserve Bank during on-site inspection of the NBFCs.

*Exposure to Related Parties*

The Reserve Bank has not issued any guidelines on related party exposures. The requirement of issuance of guidelines on arm's length relationships and stipulations on mitigating risks arising out of related party

The Reserve Bank should obtain information on the names and holdings of significant shareholders.

exposure could be examined, keeping in view the developmental and supporting role played by NBFCs in promoting greenfield projects, which they often do through subsidiaries and associates.

*Market Risk*

The Reserve Bank has not issued any instructions to NBFCs to put in place policies and processes that accurately identify, measure, monitor and control market risks. The Reserve Bank has issued ALM guidelines which are applicable to NBFC-D with deposits over Rs.20 crore and to NBFCs with an asset size of Rs 100 crore and above, irrespective of whether they accept or hold deposits. NBFCs provide financial services similar to those of banks and, as such, compete with them. The non-deposit taking NBFCs' investment portfolio comprises a significant portion of their balance sheets. Also, their off-balance sheet exposures are susceptible to market risk. The NBFC-ND-SI sector has been growing very fast and is mainly funded by borrowings which were around 66 per cent of total liabilities. Of the borrowings, the total funding from banks/FIs also constitutes a significant amount.

Thus, the NBFC-ND-SI sector has linkages with the banking system and does pose some systemic risk. As these entities have significant amounts of borrowings and investments in their portfolio, which is vulnerable to movement in interest rates, the Reserve Bank should consider the feasibility of implementing guidelines on market risk along the lines of commercial banks to deposit taking NBFCs (with deposits above Rs.20 crore) and NBFCs-ND-SI and stipulate a capital charge for market risk in a phased and calibrated manner. However, NBFCs that do not have any outstanding borrowing by way of public deposits or any other form of borrowing, including preference shares, could be considered for exemption from these guidelines. The prudential norms for NBFCs, particularly relating to ALM and liquidity risk management, need to be strengthened in a non-disruptive manner. The CFSA notes that the ALM guidelines which have been issued to NBFC-D, as mentioned above, have since been extended to NBFC-ND-SIs.

*Operational Risk*

The Reserve Bank has not issued any guidelines to NBFCs to have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. The capital adequacy requirements for NBFCs capture only credit risk. However, the capital adequacy requirements for NBFCs are higher than those for banks. The Panel felt that there is no need to issue any guidelines on capital charge for operational risk for the present to

NBFCs. However, guidelines on management of operational risk without stipulating specific charge can be issued for NBFCs.

*Internal Control*

The Reserve Bank does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination of NBFCs. The Reserve Bank needs to look into the same during the on-site inspection of NBFCs-D. Specific provisions in the NBFC inspection manual require to be made in this regard. As regards NBFCs-ND-SI, the same may be seen during on-site scrutiny.

*Abuse of Financial Services*

There is no procedure for confirmation by the Reserve Bank for money laundering prevention or identification and reporting of potential abuse. There can be confirmation that NBFCs have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering, through on-site inspection.

The Reserve Bank has issued detailed guidelines on Know Your Customer to NBFCs. However, there are no laws in place which give protection to NBFC staff who report suspicious activity in good faith, either internally or directly, to the relevant authority. Appropriate guidelines along the lines introduced for private sector banks and foreign banks (Introduction of 'Protected Disclosures Scheme for Private Sector and Foreign Banks') should be issued. The CFSA notes that as per Section 14 of the Prevention of Money Laundering Act, 2002 Financial Institutions[61] and their officers shall not be liable to any civil proceedings against them for furnishing information under the Act.

*Appointment of Auditors and Disclosure Requirements*

The Reserve Bank has no power to recommend, reject or rescind the appointment of auditors[62]. There is a need to issue appropriate guidelines to empower the Reserve Bank regarding the appointment, rejection and rescinding of external auditors. This may be done in consultation with the Institute of Chartered Accountants of India (ICAI). The CFSA in this context feels that, given the multitude of small companies in the NBFC landscape, appointing auditors could be an onerous responsibility on the Reserve Bank.

The disclosures made by NBFCs at present include both qualitative and quantitative information on their financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. In the interest of better market discipline, and in the context of increasing complexities of holding structures and multi-layering apart from the diversified activities of NBFCs, the Reserve Bank could consider increased

[61] Financial Institutions, as defined in the Act, include NBFCs.

[62] In terms of the provisions of the Companies Act, statutory auditors are to be appointed by the annual general body meeting of the company. However as a matter of prudent policy, a rotation policy of partner of the statutory auditor firm has to be considered by large NBFCs.

Increased disclosure by NBFCs could contain information on ownership structure, significant holdings and types of activities and product.

disclosures in the case of NBFCs, like ownership structure, significant holdings and nature and types of activities and products.

The CFSA concurs with the Panel that the diversification of NBFCs and growth in their asset bases depends on their access to non-deposit sources of funds, in particular borrowing through issuance of bonds. Since there are presently no restrictions on NBFCs raising resources from bonds, as and when the corporate bond market develops, this channel of raising resources could expand. The need to develop the corporate bond market has to be seen as urgent.

**Summary**

The recent global financial turmoil has highlighted the impact on systemic stability through OFIs which, in India, operate as NBFCs. In India, there are two broad categories of NBFCs, *viz.*, NBFCs-D and NBFCs-ND. The recent growth in the NBFC sector is due primarily to NBFCs–ND. The financial indicators of the NBFCs-D segment, do not throw up any major concern and is characterised by high CRAR, low NPAs and comfortable RoA.

NBFCs-ND-SI are growing at a rapid pace. The sector has been witnessing a significant improvement in financial health and is characterised by low and reducing NPAs and high RoA.

The sector's recourse to unsecured loans for funding their asset base is, however, a cause for concern. Both sectors are increasingly dependent on borrowings, which accounts for about two-thirds of their funding requirements. The present financial crisis has further aggravated the problem faced by NBFCs due to the difficult liquidity situation whereby they face problems not only in accessing funds but also encounter difficulties in lending to sectors, particularly the automobile segment. Given the funding requirements of NBFCs and their lack of access to low-cost deposits, there is a need to develop an active corporate bond market which could act as an alternate funding source.

The diversification of NBFCs and growth in their asset bases depends on their access to non-deposit sources of funds.

While there is a need to provide an environment for encouraging the development of the NBFC sector, the growth of NBFC-ND-SI reveals the need for an appropriate structure for regulation and supervision of these companies with appropriate legislative authority.

Sister concerns, *i.e.*, banks and NBFCs under the same parent company, do not fall within the ambit of consolidated supervision. To address this gap, the regulatory authorities, *viz.*, the Reserve Bank, IRDA and SEBI are

developing a process for regulation and supervision of financial conglomerates. This needs to be expedited.

An assessment of BCPs, wherever applicable, has revealed gaps in areas relating to transfer of significant ownership, major acquisitions, risk management, internal control and home-host relationship.

## 3.5 Housing Finance Companies

The emergence of organised housing finance has been a relatively late development in India. When the National Housing Bank was set up in 1988, nearly 80 per cent of the housing stock in the country was financed from informal sources. The organised sources of housing finance included, *inter alia*, the housing finance companies which then numbered about 400 and were essentially Non-Banking Financial Companies (NBFCs) that were regulated by the Reserve Bank. These included small companies with operations restricted to localised areas and companies engaged in construction/development, which also offered housing credit. Several of the companies relied on public deposits for their resources. A notable exception was the Housing Development Finance Corporation (HDFC).

The setting up of the National Housing Bank (NHB) in 1988, as a fully-owned subsidiary of the Reserve Bank with a mandate 'to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto', marked the beginning of the emergence of housing finance companies as significant financial intermediaries in the country. Since then the sector has grown with many new HFCs being set up, including several sponsored by banks and financial institutions [*e.g.*, LIC Housing Finance Ltd., GIC Housing Finance Ltd., BOB Housing Ltd. (since merged with its parent bank-Bank of Baroda), PNB Housing Finance Ltd., IDBI Home Finance Ltd., and ICICI Home Finance Ltd.]; some of these with equity support from the NHB as part of their developmental mandate. This provided aspiring potential home owners with access to housing finance and facilitated home ownership in a big way.

Against the milieu of rapid urbanisation and a changing socio-economic scenario, the demand for housing in the country has been expanding at a fast pace. According to the National Buildings Organisation (NBO)[63], the total demand for housing was estimated at 2 million units per year and the total housing shortfall was estimated to be 19.4 million units, of which 12.8 million units was from rural areas and 6.6 million units from urban areas. It is estimated that the budgeted 2 million units would lead to the creation of an additional 10 million man-years of direct employment and another 15 million

[63] The National Buildings Organisation was established by the Government of India in 1954 as an attached office under the control of the then Ministry of Urban Development for technology transfer and experimentation and dissemination of housing statistics. With the requirements under the National Housing Policy to strengthen the management information system and various other socio-economic and statistical functions connected with housing and building activities, the National Buildings Organisation was restructured in August, 1992.

The National Housing Policy had envisaged an investment target of Rs.1,50,000 crore for the housing sector.

man-years of indirect employment. Having identified housing as a priority area in the Ninth Five Year Plan (1997-2002), the National Housing Policy had envisaged an investment target of Rs.1,50,000 crore for this sector.

The urban housing shortage had been estimated at about 24.7 million units at the end of the 10th Five Year Plan (2006-07) of which 99 per cent pertained to the economically weaker section (EWS) and low-income group (LIG) categories. The rural housing shortage is estimated at 7 million units.

### 3.5.1 Performance

### 3.5.11 Growth and Composition

The significant growth in housing finance in recent years has seen the share of housing loans as a proportion to GDP increasing from 3.4 per cent in 2001 to 7.4 per cent by 2008. There has been some moderation in the growth of housing loans since 2006. In spite of the increasing foray of banks into the housing sector (Scheduled commercial banks accounted for more than 70 per cent of total outstanding housing loans), the outstanding housing loan amount of HFCs was significant at Rs.98,025 crore as at end-March 2008. The total disbursement of housing finance by HFCs was Rs.46,164 crore during 2007-08. HFCs have been facing very stiff competition from banks and their share in the housing loan segment has generally been declining. However, the sector still accounted for around 34 per cent of housing loan disbursement in 2005-06. The CFSA observes that given the dominance of the housing loan portfolio in HFCs' balance sheets, the declining share of housing loan disbursement could impact future growth in this sector (Table 3.26).

High borrowings of HFCs points to the systemic linkage of such institutions.

The asset base of HFCs is primarily funded by borrowings. The housing loans portfolio constitutes almost two-thirds of their asset base. HFCs had public deposits to the tune of Rs.12,900 crore and borrowings of Rs.1,01,600 crore (of which borrowings from banks stood at Rs.48,800 crore) as on March 31, 2007, thereby having a systemic linkage. The largest HFC[64] is also a financial conglomerate, which has made forays into several sectors including

**Table 3.26: Key Balance Sheet Components of HFCs as Percentage to Total Assets**

| | Public Deposits | Borrowings | Housing Loans |
|---|---|---|---|
| Mar-06 | 10.1 | 75.4 | 64.7 |
| Mar-07 | 9.6 | 74.3 | 65.9 |

**Source:** NHB.

[64] The largest HFC is HDFC Ltd. The share of HDFC in total housing loans financed by HFCs was 52 per cent as on March 31, 2008.

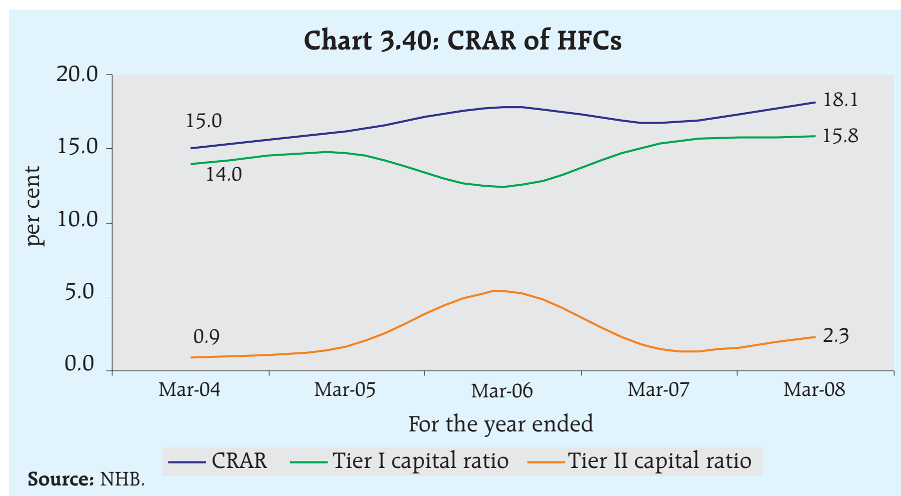
banking. A significant aspect of HFCs is their leveraged positions. The reliance of HFCs on public deposits appears limited, with the ratio of public deposits to total borrowings consistently declining.

### 3.5.12 Financial Soundness

*Capital Adequacy*

On average, housing finance companies have been able to maintain CRAR well above the prescribed level of 12 per cent, with the overwhelming portion comprising core capital. The low tier II capital of HFCs implies that there is significant headroom for these entities to expand their capital base (Chart 3.40).

**Chart 3.40: CRAR of HFCs**

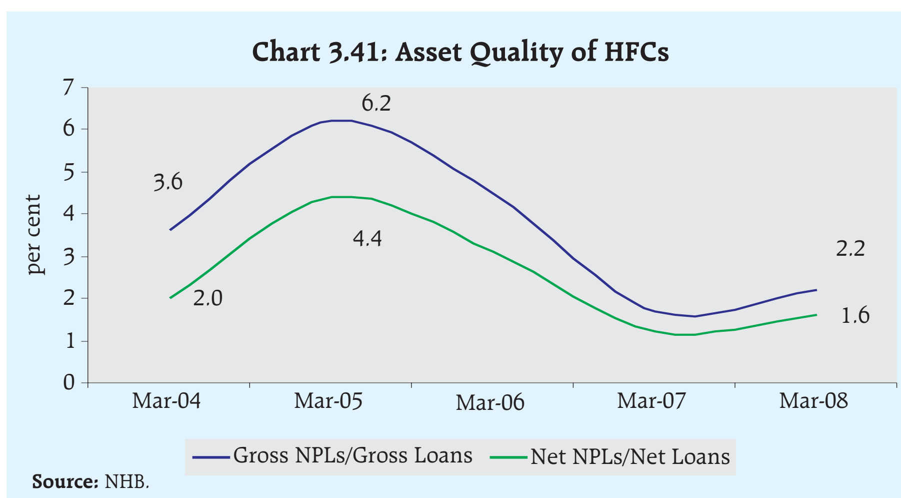



**Source:** NHB.

*Asset Quality*

The asset quality of housing loans is an area of concern given the propensity of such loans to turn into impaired assets in the event of an economic downturn. The data indicates that NPA ratios for HFCs are, however, moderate. The decline in asset quality observed during 2004-05 mainly reflects the impact of the introduction of the 90-day norm for asset classification with effect from end-March, 2005 (Chart 3.41).

**Chart 3.41: Asset Quality of HFCs**



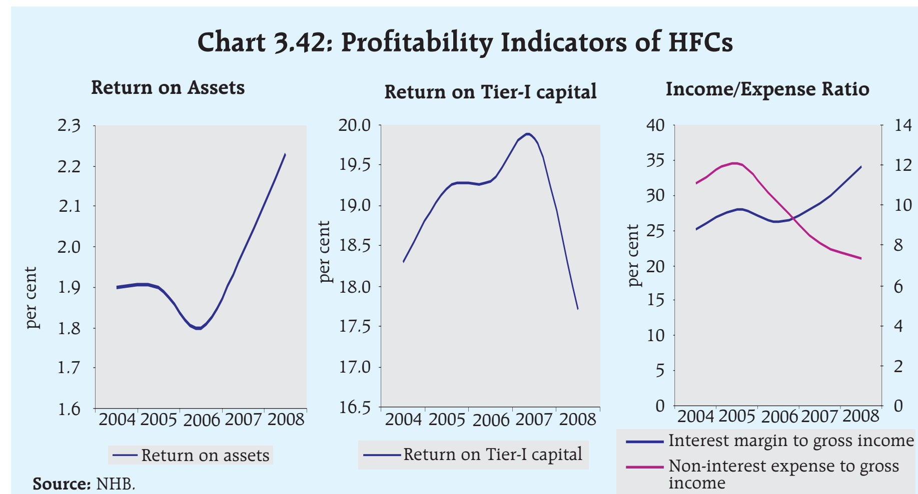

**Source:** NHB.

The housing finance companies have been able to maintain CRAR well above the prescribed level of 12 per cent

*Earnings and Profitability*

Both return on assets (RoA) and return on tier I capital improved in 2007; however, return on tier I capital declined in 2008. The sector exhibits high potential as evidenced from the consistently higher levels of interest margin to gross income ratio (Chart 3.42).

**Chart 3.42: Profitability Indicators of HFCs**

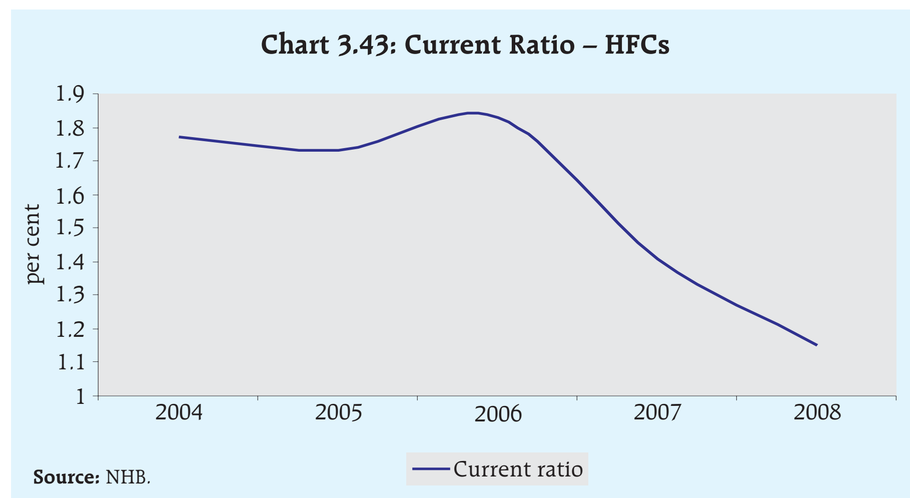



**Source:** NHB.

*Liquidity*

Though there was some decline from 2006-07, the HFCs are comfortably placed in terms of liquidity as indicated by their current ratio[65] till end-March 2008 (Chart 3.43). However, most HFCs have been experiencing liquidity

**Chart 3.43: Current Ratio – HFCs**




**Source:** NHB.

[65] This ratio indicates current assets to current liabilities.

problem from October during the current year, *i.e.*, 2008-09. This has been primarily caused by the overall liquidity shortage in the beginning of the year as also increased reliance on short-term market borrowings which, during the current year, dried up due to liquidity problems faced by major investors, such as mutual funds. Strengthening the financial position of NHB, which has been designated a refinancing institution for housing, would partly address the issue of liquidity of HFCs.

Though financial soundness indicators of HFCs are healthy there is some concern on the liquidity front.

**3.5.2 Issues and Concerns**

**3.5.21 Housing Price Index**

Internationally, most countries employ housing prices as part of their assessment of the asset price channel of monetary policy. Given the lack of data on housing prices in India, assessing the extent of activity in this segment becomes a challenging task for policymakers. Due to the non-availability of a nation-wide housing price index, an accurate estimate of Loan to Value (LTV) ratio becomes difficult. Mr. Andrew Sheng, peer reviewer, highlighted the role that prudential LTV ratios played in protecting banks in Hong Kong and Spain against asset bubbles and pointed out that the construction of a housing price index is a matter of priority. To initiate the process of having a pricing index for the housing sector, the NHB has developed a housing price index based on a pilot phase for five cities, *viz.*, Mumbai, Bhopal, Bangalore, Delhi and Kolkata. Currently there are plans to expand the pilot phase from 5 to 15 cities. Over time, it is expected to cover 63 cities with populations of more than 10 lakh. This should be supplemented by a 'housing start-up index' to provide insights on the elasticity of property supply to property prices as well as the cost of housing credit. In addition, the Reserve Bank, on its own, undertook two different surveys/studies to identify real estate price movements in Mumbai which covered the prices of residential and commercial properties, including rent and sale/resale transactions of six zones in Greater Mumbai and seven adjacent municipalities. This study developed separate price indices for sale/resale prices and rent of commercial and residential buildings. Given the recent developments in the housing market the world over, which have underscored the need for better monitoring of real estate prices, it has been decided to establish an appropriate statistical data collection system within the Reserve Bank for which it has constituted an expert group. The proposed 'Asset Price Monitoring System' is expected to cover in a timely manner the key essence of real estate price movements, including the sale/resale/rent of residential/ commercial property in representative locations. Keeping in mind the importance of such an indicator for the central bank, the Reserve Bank constituted a Technical Advisory Group (TAG) on Development of Housing Start Up Index. The CFSA notes that the TAG in its report submitted in January 2009, has formulated a feasible methodology for the construction of a housing start-up index in India on a regular basis and proposed an institutional structure that would be responsible for its operationalisation.

Work on constructing a national housing price index needs to be completed on a priority basis.

The National Buildings Organisation (NBO) under the Ministry of Housing and Urban Poverty Alleviation could play an important role in the compilation of the housing start-up index.

### 3.5.22 Issues Relating to Delinquency

Though the housing sector has been witnessing a Compounded Annual Growth Rate (CAGR) of over 30 per cent over three years ending 2005-06, the growth in monthly household income in the corresponding period is considerably lower at 20 per cent[66]. The banking sector has also witnessed credit growth in excess of 30 per cent during this period one major component being the retail sector, which includes housing finance though some moderation in housing loan growth has been observed in very recent times. Concern has been expressed that the rise in real estate prices and buoyancy witnessed in the stock market may be out of sync with the fundamentals. Given the hardening of interest rates in the recent past, this has led to an increase in the household debt burden and a resultant elongation of the repayment period for housing loans. There are concerns that this sector may witness an increase in delinquency rates in the event of a decline in housing prices. The CFSA feels that prudential policies for stability should address this issue.

### 3.5.23 Regulator and Supervisor

The National Housing Bank (NHB) was established to function as the principal agency to promote housing finance institutions and to provide financial and other support to such institutions. It is empowered to issue directions to housing finance institutions to ensure their growth along sound lines; make loans and advances and render any other form of financial assistance to scheduled banks and housing finance institutions or to any authority established by or under any Central, State or Provincial Act and engaged in slum improvement; and formulate schemes for the purpose of mobilisation of resources and extension of credit for housing.

Housing sector may witness increased delinquency in the event of fall in housing prices and hardening of interest rates.

The CFSA observes that there has been a decline in the number of HFCs (around 43, with 12 of them doing 90 per cent of the business) and that scheduled commercial banks are currently the dominant players in the housing loan market. In view of the decline in the number of HFCs as also the fact that HFCs are technically NBFCs, the regulation of these entities could be vested with the Reserve Bank, leaving the NHB with only its developmental

[66] Rupali Shanker. Mortgage Finance - Defining Affordability and Debt Burden. CRISIL.

function to avoid any conflict of interest. However, the Government feels that there is no conflict of interest in NHB combining its development and regulatory role as has been done by many other regulatory agencies like SEBI, IRDA, and TRAI. It feels that since the housing market in India is in its early stage of development, combining the regulatory and developmental functions into a single agency such as NHB is beneficial for the market.

### 3.5.24 Development of Government-sponsored Secondary Mortgage Vehicle

Mr. Andrew Sheng, the peer reviewer, suggested that consideration could be given to create one or two government-sponsored secondary mortgage vehicles (with private management and ownership participation) to develop a healthy mortgage market. The Advisory Panel on Financial Stability Assessment and Stress Testing thought that, in view of the fiscal implications involved, a government-sponsored/guaranteed secondary mortgage vehicle was not appropriate at this juncture. The CFSA noted that Fannie Mae and Freddie Mac, which enjoy an implicit government guarantee, have been taken over by the US Treasury recently. In light of these developments, as also the observations of the Panel, it felt that at the present time it was not opportune to go for these kinds of vehicles; however, the idea needs to be studied carefully.

The time is not ripe to consider a Fannie Mae/Freddie Mac-type of arrangement.

### 3.5.25 Assessment of Basel Core Prinicples

Based on the assessment of Basel Core Principles, wherever the adherence is not compliant or materially non-compliant (the details of which are furnished in Annex-Section-V), the Advisory Panel on Financial Regulation and Supervision had made appropriate recommendations. These recommendations are based on the assumption that NHB continues as the regulator and supervisor of the HFCs. The CFSA feels that the views of the Advisory Panel, which are summarised below, could be considered.

*Regulatory Co-operation*

There is a need for coordination and information exchange between home supervisors and the NHB. A formalisation of the relationship with foreign regulators is also necessary[67]. There should be specific provisions in the NHB Act, 1987 along the lines of the SEBI Act, 1992, so that MoUs can be entered into with foreign supervisors for establishing a formal communication mechanism.

There is a need to obtain a no-objection certificate from the home supervisor in the case of foreign HFCs intending to open a branch in India and in respect of HFCs which are wholly/significantly owned by foreign entities. The NHB should assess whether the home supervisor practises global consolidated supervision.

[67] As on March 31, 2008 there are seven HFCs that have significant foreign investment, *viz.*, AIG Home Finance Ltd. (formerly Weizmann Homes Ltd.), BHW Home Finance Ltd. (formerly Birla Home Finance Ltd., since bought by Deutsche Postbank), HDFC Ltd. (overseas institutional holding about 62%), Repco Home Finance Ltd. (investment from the Carlyle Group), GE Money Housing Finance (unlimited liability company) and Sundaram BNP Paribas.

The National Housing Bank Act should clearly delineate the permissible activities of HFCs

While assessing the foreign shareholding of HFCs, only Foreign Direct Investment (FDI) is taken into account. There is a need to reckon FIIs investments as part of the foreign shareholding of HFCs. The CFSA notes that this should not mean reduction in FDI limits, but there should be strong regulations in place to guard against contagion from outside.

*Permissible Activities, Composition of the Board, Ownership and Major Acquisitions*

The National Housing Bank Act should clearly define a housing finance company or housing finance institution, clearly delineating their permissible activities. Builders/construction companies should not be permitted to use the term 'housing finance' in their names and the Ministry of Corporate Affairs needs to issue necessary guidelines to Registrars of Companies in this regard.

The NHB should issue appropriate guidelines establishing the responsibilities of the board and senior management with respect to corporate governance to ensure that there is effective control over an HFC's entire business. Fit and proper guidelines by HFCs should include an examination of the track record of promoters and senior management. The guidelines should ensure that the board collectively has a sound knowledge of each type of activity that each HFC intends to pursue and the associated risks.

An amendment to the NHB Act or issuance of appropriate guidelines should be considered to empower the NHB to bring about changes in the composition of the board and senior management to address any prudential concerns.

There is no clear definition of 'significant ownership' or 'controlling interest' in the case of HFCs. The NHB may, in consultation with the Reserve Bank, examine this issue and provide for a clear definition of 'significant ownership' and 'controlling interest'.

Fit and proper guidelines by HFCs should include an examination of the track record of promoters and senior management.

The NHB needs to lay down norms for acquisition or investment by an HFC, taking into account the entity's financial and organisational resources and the risks that could emanate from such an acquisition.

*Large exposure limits, exposure to related parties and provisioning for off-balance sheet items*

The NHB should issue necessary guidelines to HFCs to establish thresholds for acceptable concentration of credit. There should be asset classification and provisioning norms specified for off-balance sheet items.

The NHB should monitor related party exposures to avoid conflicts of interest. Furthermore, the NHB needs to take steps to mitigate the risks arising from exposure to related parties. As a first step in this direction, the NHB can define and capture information on related parties from HFCs and also put in place a mechanism to review the same. On the basis of the review, potential risk areas may be identified and suitable guidelines contemplated to mitigate such risks.

*Risk Management*

The NHB needs to issue guidelines on market risk along the lines of commercial banks for HFCs. This can be done in a phased manner. At the outset, surrogate risk weights can be stipulated for instruments susceptible to market risk. In the second stage, the assets can be segregated into banking book and trading book. Capital charge on market risk for items in the trading book may be considered.

The NHB has not issued any detailed liquidity risk management guidelines other than ALM guidelines for larger HFCs. The guidelines should be more exhaustive and should cover aspects like the existence of a contingent plan to handle liquidity problems. It should also obtain information to identify institutions that are carrying out significant liquidity transformations.

The capital adequacy requirements for HFCs capture credit risk that is higher than the minimum stipulated risk-based capital requirement for banks. The NHB should consider issuing management of operational risk guidelines to HFCs, though capital charge for operational risk need not be earmarked at this stage.

*Internal Control and Audit and KYC Norms*

The NHB does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination. Considering the level of operations of most HFCs, such a prescription may not be warranted. The NHB could explore the feasibility of introducing such a practice.

As regards KYC guidelines, the NHB needs to explore the introduction of the following practices:

- Determination of whether financial conglomerates have a permanent compliance function that assists senior management in effectively managing the compliance risks faced by HFCs.
- Satisfying itself that HFCs have adequate screening policies and processes to ensure high ethical and professional standards when hiring staff.
- Determination of whether the HFCs have clear policies and processes for staff to report any problems related to the abuse of the HFCs' financial services to either local management or the relevant dedicated officer or to both.

The NHB should monitor related party exposures to avoid conflicts of interest.

- Issuance of guidelines which protect HFC staff who report suspicious activity in good faith, either internally or directly, to relevant authority.
- Issuance of guidelines ensuring whether the system of risk management and internal controls and detection/prevention of criminal activities and oversight of outsourced functions is in place in HFCs.

*Supervisory approach, accounting and disclosure issues*

The NHB needs to put in place a structured mechanism that requires HFCs to notify the NHB of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.

There is a need to issue appropriate guidelines to empower the NHB regarding the appointment, rejection and rescinding of external auditors. This may be done in consultation with ICAI. The CFSA, however, thinks that the task of appointing auditors may be too onerous for the NHB. Even so, the NHB needs to have powers regarding rejection and rescinding of auditors.

HFCs are not required to submit consolidated financial statements to the NHB, though the largest HFC is a financial conglomerate. There is a need to issue guidelines (i) mandating the housing finance companies to submit consolidated financial statements and consolidated prudential returns; and (ii) empowering the NHB to conduct consolidated supervision through appropriate amendment to the NHB Act, 1987.

**3.5.3 Summary**

According to the National Buildings Organisation (NBO), the total demand for housing was estimated at 2 million units per year and the total housing shortfall was estimated to be 19.4 million units. The urban housing shortage was estimated at about 24.7 million units at the end of the 10th Five Year Plan (2006-07). The two major sets of institutions providing housing finance are HFCs and banks. HFCs have been facing competition from banks and their share in the housing loan segment has generally been declining.

HFCs should be mandated to furnish consolidated financial statement.

An assessment of the financial soundness of HFCs shows that the housing finance companies have generally been able to maintain CRAR well above the prescribed level of 12 per cent. Their asset quality indicators are robust and Return on Assets (RoA) after dipping in 2005 and 2006 increased in

2007 and 2008. HFCs are comfortably placed in terms of liquidity, as indicated by their current ratio. However, most HFCs have been experiencing liquidity problem from October during the current year, *i.e.*, 2008-09. Strengthening the financial position of NHB, which is the designated refinancing institution for HFCs, would help address the liquidity problem faced by HFCs.

India does not have a national housing price index and this hinders the calculation of the Loan to Value (LTV) ratio for the housing finance sector. In order to obtain an estimate of the LTV ratio, the construction of a national housing price index becomes a priority. This should be supplemented by a 'housing start-up index' to provide insights on the elasticity of property supply to property prices, as well as the cost of housing credit.

Hardening interest rates could elongate loan maturities and result in increased delinquencies in this sector in time to come.

Since HFCs are technically NBFCs, the regulation of these entities could be vested with the Reserve Bank, leaving the NHB with only its developmental function to avoid any conflict of interest. However, the Government feels that there is no conflict of interest in NHB combining the development and regulatory roles as has been done by many other agencies like SEBI, IRDA, and TRAI. Further, it also feels that since the housing market is in its infancy in the country, it would be beneficial for the market to vest both regulatory and development functions with a single entity, *viz.*, NHB.

An assessment of Basel Core Principles (BCPs), wherever applicable, reveals gaps in areas relating to home-host co-operation, permissible activities, exposure to related parties, risk management and internal control.

## 3.6 Development Finance Institutions

Development Finance Institutions (DFIs) in India have had a long and successful history and were visualised in a role complementary to commercial banks and other private financial agents, primarily to fill the gaps in lending activities of long gestation that were not catered to by the commercial banks. Unlike traditional commercial banks which depended upon multiple credit creation from deposits to mobilise resources, DFIs did not have access to deposits from the public and differed from them in the type, use and cost of resources.

The Industrial Finance Corporation of India (IFCI) was the first DFI and was set up in 1948, marking the beginning of the era of development banking in India. The Industrial Credit and Investment Corporation of India (ICICI) Ltd. was set up in 1955 to provide long- and medium-term assistance in the form of loans or equity participation for the creation, expansion and modernisation of individual enterprises. Among other DFIs, the Unit Trust of India and the Industrial Development Bank of India were set up in 1964 and, thereafter, the various State Financial Corporations (SFCs). The Export-Import Bank of India (EXIM Bank) was set up in 1982 as a co-ordinating agency in the field of international finance that was responsible for the development of

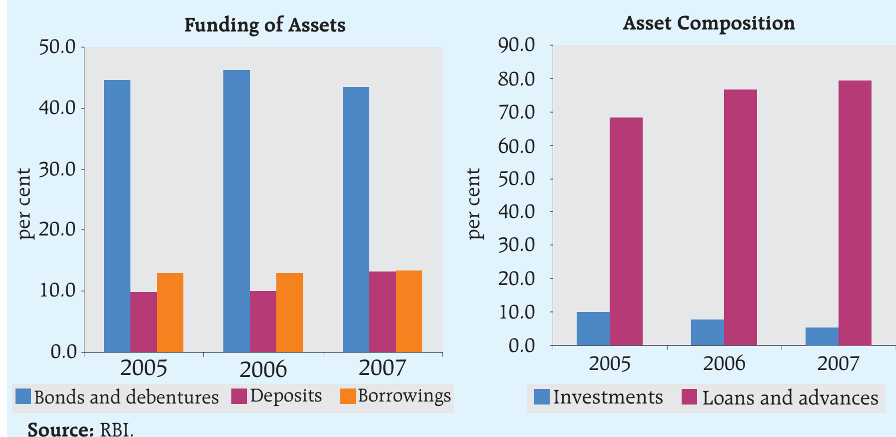
DFIs are unable to compete with banks.

merchant banking activities in export-oriented industries. The Small Industries Development Bank of India (SIDBI) is the principal financial institution for the promotion of financing and development of industry in the small, tiny and cottage sectors and for the co-ordination of the functions of the other institutions engaged in similar activities. The National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982 to finance the agricultural and rural sectors. While DFIs have played a very important catalytic role in the entire development process with the introduction of financial sector reforms in the nineties, commercial banks too started providing longer-term finance to the corporate sector. Given their inability to access lower-cost finance, the DFIs were not able to compete with the banks. Their problem was compounded by increases in loan delinquency in their credit portfolio. Development financial institutions have shrunk and have amalgamated with their banking counterparts.

Some of the major all-India financial institutions (term-lending and re-finance institutions) have amalgamated with their banking counterparts over the past few years. Some of the DFIs have been reclassified as systemically important non-deposit taking NBFCs[68]. The outstanding loans had reduced from Rs.1,67,201 crore as at end-March 2000 to Rs.1,33,061 crore by end-March 2004 (Chart 3.44). Since 2004, there has been a growth in the loan portfolio of FIs which at Rs.1,49,692 crore as at end-March 2008 is still lower

Development finance institutions have shrunk and have amalgamated with their banking counterparts or turned into NBFCs.

**Chart 3.44: Balance Sheet Indicators of DFIs**




**Source:** RBI.

[68] FIs not accepting public deposits with asset size of Rs.500 crore and above are subject to limited off-site supervision. Included in this category is TFCI, while IIBI is in the process of voluntary winding up. IFCI is presently regulated as a systemically important non-deposit taking NBFC.

than its March 2000 position. The gradual shrinkage of this sector is reflected in the fact that their share in total financial sector assets at end-March 2008 was only 2.4 per cent.

The main funding source for DFIs has been bonds and debentures which are typically more expensive than deposits. As a result, the position of DFIs is becoming increasingly less competitive *vis-à-vis* banks which have access to low-cost Current Account Savings Account (CASA) deposits. In keeping with the increasing trend in interest rates from 2004 onwards, there has been an increase in the cost of borrowings of DFIs. The weighted average maturity of rupee resources of DFIs has also declined significantly over the past few years, from an average of over 6 years to around 4 years. The change in the operating environment, coupled with increased competition and availability of alternative modes of finance to the corporates and the organisational restructuring being faced by these institutions, *inter alia*, have also led to the declining share of business of these financial institutions.

*Financial Soundness*

Despite their shrinking business, the financial performance of DFIs is satisfactory. The aggregate CRAR of DFIs stood at 25.6 per cent at end-March 2008. Reflecting the combined effect of better recovery management and improved provisioning, net NPAs witnessed a sharp decline and stood at 0.1 per cent at end-March 2008. With the economic upturn over the past few years (till 2008), there has been an improvement in the asset quality as evinced from the decline in NPA ratios as well as their absolute levels. These results, however, should be viewed in light of the fact that income recognition and asset classification for DFIs have only recently been placed on par with those for banks[69] (Table 3.27).

The operating and net profit of these entities grew by 30 per cent and 23 per cent, respectively, during 2007-08.

*Summary*

Due to their inability to access lower cost finance, DFIs are unable to compete with banks. There has been a gradual decline in their share of total financial assets.

**Table 3.27: Profile of DFIs**

| | | | (per cent) |
|---|---|---|---|
| **Item** | **2005-06** | **2006-07** | **2007-08** |
| CRAR | 30.7 | 25.9 | 25.6 |
| Gross NPL Ratio | 1.3 | 0.8 | 0.5 |
| Net NPL Ratio | 0.9 | 0.1 | 0.1 |
| Net profit/Total asset | 1.2 | 1.0 | 1.1 |

**Note :** Data for 2005-06 and 2006-07 cover only four DFIs currently being regulated by RBI.
**Source:** RBI

[69] For DFIs, with effect from end-March 2006, an asset would be classified as non-performing if the interest and/or instalment of principal remains overdue for more than 90 days. DFIs would have the option to phase out the additional provisioning required for moving over to the 90-day income recognition norm over a period of three years beginning from the year ending March 31, 2006, subject to at least one-fourth of the additional provisioning being made in each year.

Despite their shrinking business, the financial performance of DFIs is satisfactory.

Though there would be difficulties in enhancing the FDI limits for the insurance sector due to global financial crisis, this needs to be addressed in the medium term.

## 3.7 Insurance Sector

After a long period of a monopolistic environment, the insurance sector was opened to private participation with the enactment of the Insurance Regulatory and Development Authority Act in 1999. Since then, the number of participants has increased from six wholly public-owned insurers to 37 insurers operating in life, general and reinsurance, in both the public and private sectors.

Participation by foreign joint venture partners through the FDI route is limited to 26 per cent of the paid-up capital under the current legislation. Through this route, foreign players have also entered the Indian insurance market. There are proposals under consideration to increase this FDI cap to 49 per cent (Insurance Laws Amendment Bill, 2008 has been tabled in the Parliament). The CFSA notes that the Government has for quite some time been emphasising the need to enhance the limits for FDI ceilings. Though, in the immediate future, this would present difficulties owing to the global financial turmoil and the absence of an enabling statutory framework, it needs to be addressed in the medium term.

The presence of new players in the market has resulted in enhanced product innovation, better services and value-added benefits. A significant component of growth in the life sector has been savings-linked insurance products. Public sector companies require time to mould themselves to the competitive environment and associated contemporary structural changes, though the post-deregulation period has seen greater diversification in their product offerings, with added stress on marketing and distribution strategies. The regulatory policy has taken a cautious and calibrated approach in sequencing various elements of the reform process, which aims not only at a level playing field, but also takes into account the structural constraints in the insurance sector.

### 3.7.1 Performance

#### 3.7.11 Growth and Competition

General insurance has grown more rapidly in the private sector.

The size of the insurance business has been increasing. The life insurance segment witnessed an average annual growth of 43.8 per cent in first-year premium between 2000-01 and 2007-08 and general insurance witnessed an average annual growth rate of 17 per cent during the same period. While the growth in both private and public sectors is comparable in the life sector, the general insurance sector saw a higher growth in the private sector.

There has also been an increase in insurance penetration. Underwritten premium in a given year to GDP ratio has increased, from 2.3 per cent in 2000 to 4.7 per cent in 2007. This compares favourably with some of the emerging economies in Asia, *i.e.*, Malaysia, Thailand and China with ratios of 4.9, 3.5 and 2.7 per cent respectively.

Insurance density, which is defined as the ratio of premium underwritten in a given year to total population (per capita premium underwritten), has increased significantly from Rs.465 (US $ 9.9)[70] to Rs.2190 (US $ 46.6) between 2001 and 2007. This is still lower than in other Asian emerging market economies; the comparable figures for Malaysia, Thailand and China are US $ 292.2, 110.1 and 53.5, respectively. Premia as a per cent of GDP, however, compared well in respect of life, though it lagged behind in non-life (Table 3.28).

**Table 3.28: Premia as a Per Cent of GDP**

| Country | Life insurance premia | | Non-life insurance premia | |
|---|---|---|---|---|
| | 2001 | 2005 | 2001 | 2005 |
| India | 2.11 | **4.00*** | 0.55 | **0.60*** |
| Malaysia | 2.96 | 3.68 | 1.75 | 1.86 |
| Thailand | 1.83 | 1.83 | 0.90 | 0.92 |
| China | 1.34 | 1.77 | 1.07 | 1.61 |

*pertains to 2007
**Source:** IRDA

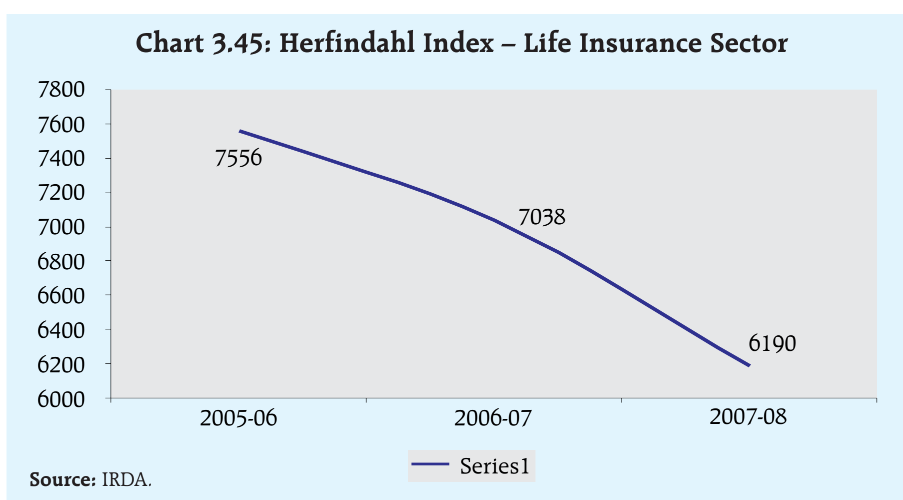
The Herfindahl Index for concentration for the life insurance industry is very high due to the dominance of the Life Insurance Corporation of India (LIC). Growing competition in the sector is, however, evident from the decline in the index over the years (Chart 3.45).

### 3.7.12 Financial soundness

#### *Life insurance*

The life insurance segment is dominated by the public sector Life Insurance Corporation (LIC), and there is significant variance between the

**Chart 3.45: Herfindahl Index – Life Insurance Sector**




**Source:** IRDA.

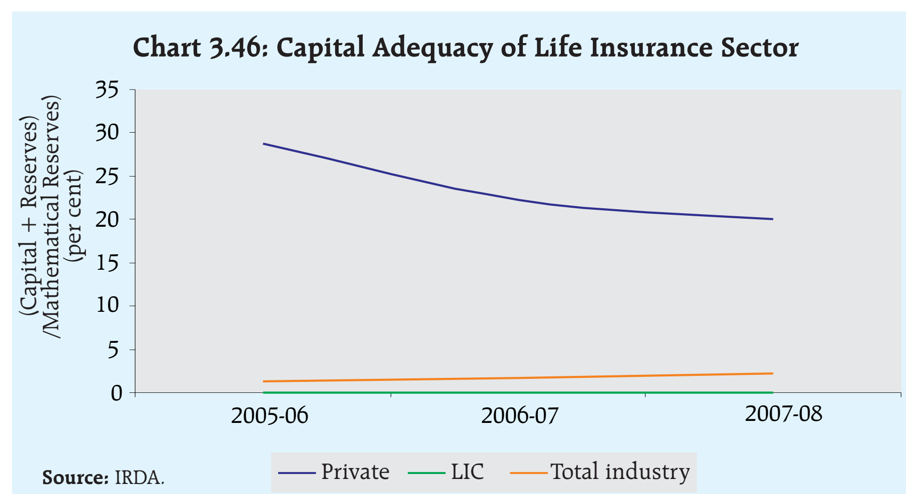
[70] Assuming rate of US$1=Rs.47.

business models of LIC and private sector participants. Accordingly, the financial soundness indicators are analysed separately for these two categories to better understand the underlying difference between the two segments.

*Solvency and Capital Adequacy*

The weighted solvency ratio for the life insurance sector shows an increasing trend and has increased from 134.1 per cent to 159.5 per cent, indicating a increase in the available solvency margin relative to the required. LIC's solvency ratio, which increased to 152 per cent by 2008 from 130 per cent in 2006, still remains relatively low compared to other players in the life insurance segment (Chart 3.46).

**Chart 3.46: Capital Adequacy of Life Insurance Sector**




**Source:** IRDA.

The stipulated solvency requirement as per regulation is based on a formula approach. Solvency ratio and entry level capital requirement are the tools used with regard to capital adequacy requirement for the insurance sector. Capital adequacy for the purpose of the analysis, which is measured by the ratio of capital + reserves and surplus to total mathematical reserves[71], is low. This is mainly due to the low capital base of LIC, the dominant component of the life insurance industry. The solvency ratio, though consistently higher than the stipulated solvency requirement, had shown a decline till 2006-07 before exhibiting an increase in 2007-08 for private sector companies.

Solvency ratio and entry level capital requirement are the tools used with regard to capital adequacy requirement for the insurance sector.

*Asset Quality*

The asset quality of the insurance sector is measured in terms of the potential volatility of its investment portfolio, and is looked at from the ratio

[71] Mathematical reserve is the amount that a life insurance company must set aside and capitalise in order to meet its future obligations.

of its equity investment to non-linked/linked investment. There has been some increase in these ratios, though they are well within the regulatory stipulations (Chart 3.47).

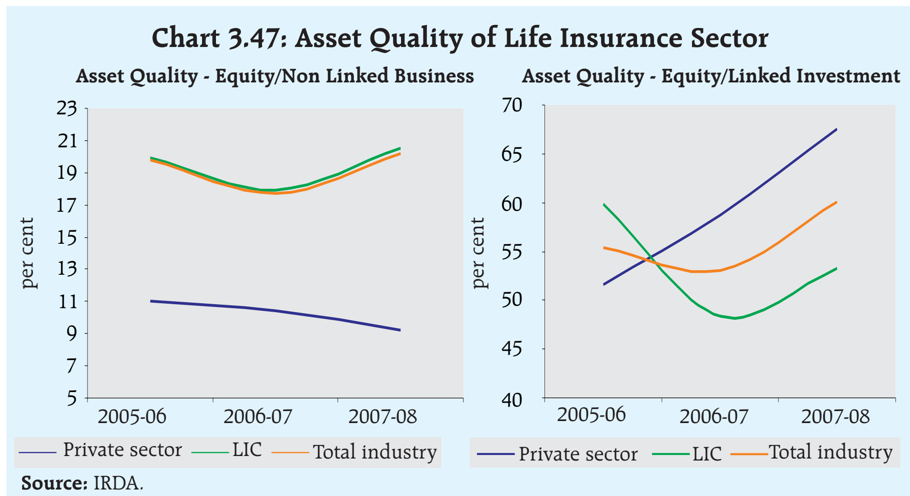



**Chart 3.47: Asset Quality of Life Insurance Sector**

**Source:** IRDA.

*Reinsurance and Actuarial Issues*

The ratio of net to gross premium remains stable at nearly 100 per cent. The ratio reflects the risk retention policy of the insurer (Chart 3.48).

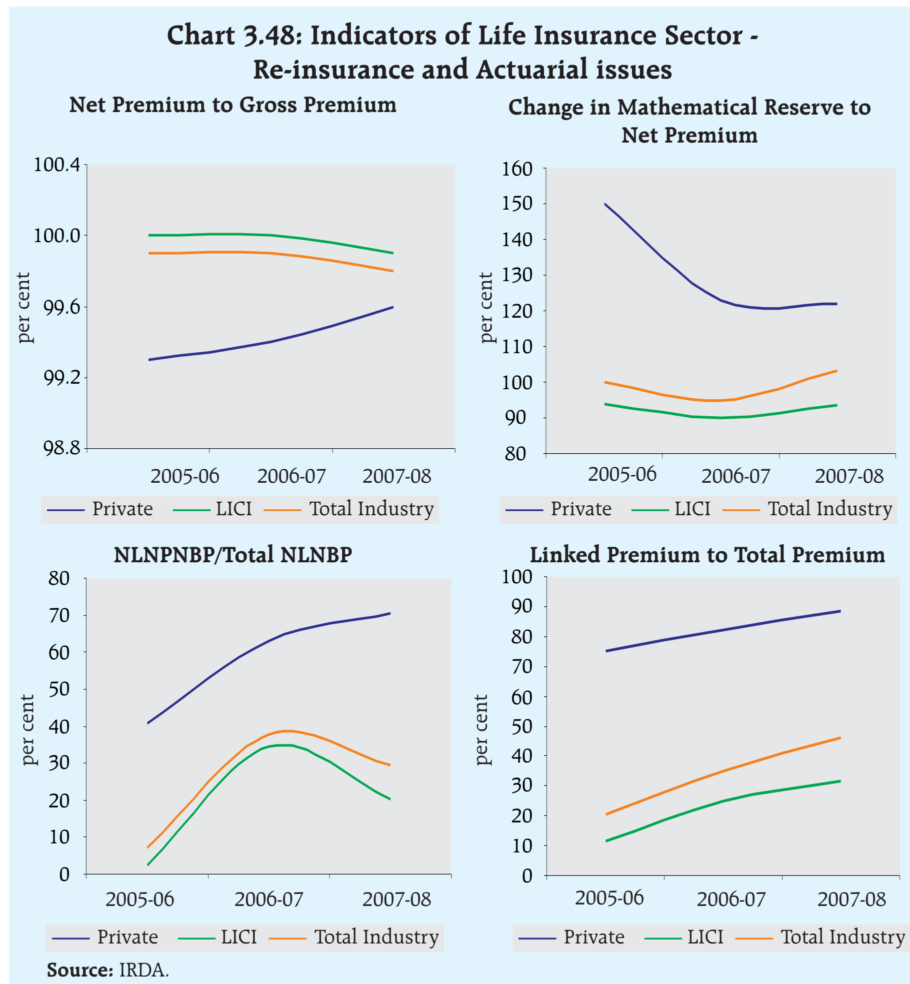


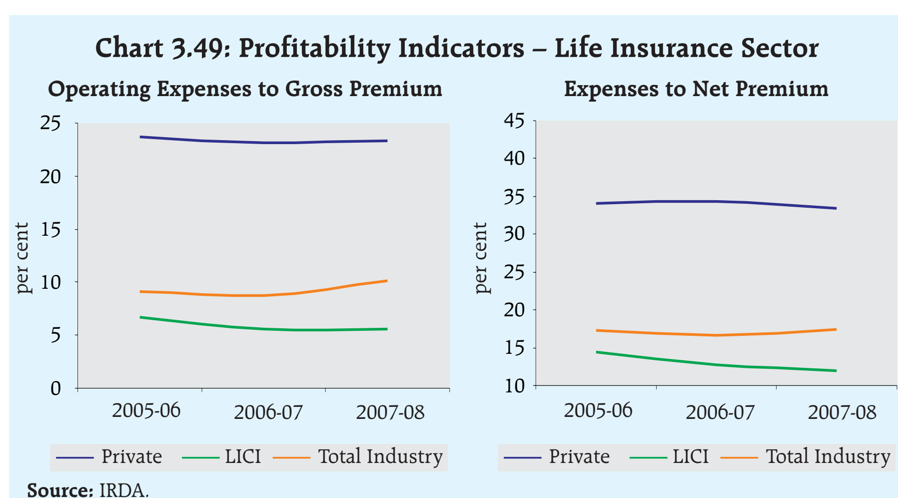

**Chart 3.48: Indicators of Life Insurance Sector - Re-insurance and Actuarial issues**

**Source:** IRDA.

*Earnings and Profitability*

While operating expenses to gross premium after showing a decline has shown an increasing trend, the wide difference in the quantum of total expenses to net premium between the private insurers and LIC is an indication of the maturity structure of the business portfolio of LIC (Chart 3.49).

**Chart 3.49: Profitability Indicators – Life Insurance Sector**




**Source:** IRDA.

*Liquidity*

The cash and bank balances of life insurers are sufficient to meet immediate liability towards 'claims towards payments but not paid'. It also covers the incurred, but not reported, portion of the claims liabilities.

***Non-Life Insurance***

*Solvency and Capital Adequacy*

The weighted solvency ratio of the non-life sector was significantly above the stipulated 150 per cent.

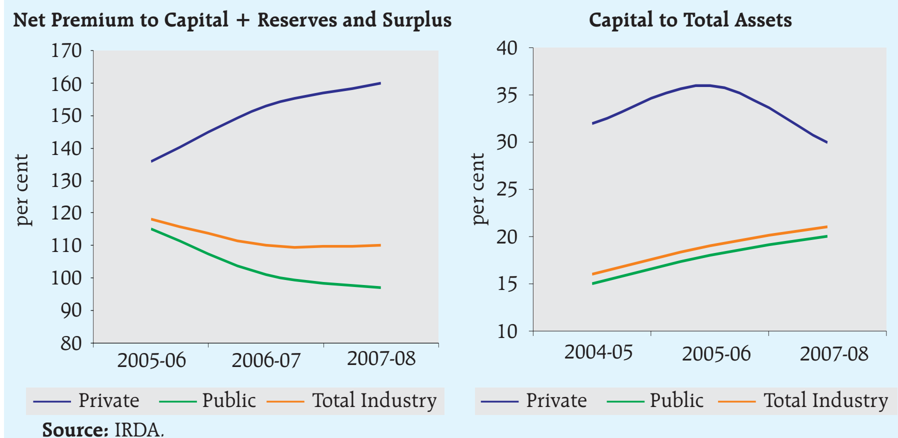
The propensity to reinsure is much higher in the non-life sector than in the life insurance segment.

The lower and declining capital base relative to the net premium of the private sector non-life companies is evident from their increasing net premium to capital ratio. The asset risk of these companies also shows a slight increasing trend, as evidenced from their marginally declining capital to assets ratio between 2005-06 and 2007-08 (Chart 3.50).

*Reinsurance and Actuarial Issues*

The propensity to reinsure is much higher in the non-life sector than in the life insurance segment. In the case of non-life insurers, the private sector

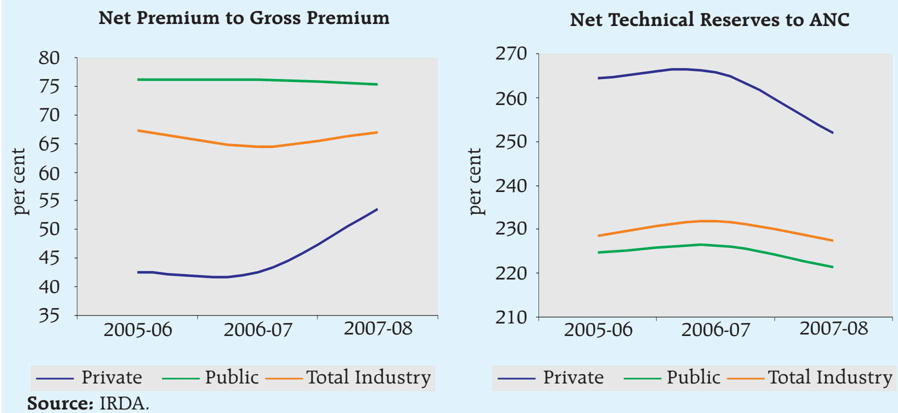
**Chart 3.50: Capital Adequacy Indicators of Non-Life Insurance Sector**




**Source:** IRDA.

is more inclined to reinsure risk. There is a slight decline in the ratio of net technical reserves to average of net claims(Chart 3.51).

**Chart 3.51: Indicators of Non-Life Insurance Sector - Re-insurance and Actuarial issues**




**Source:** IRDA.

Public sector companies have larger investment assets than their private sector counterparts.

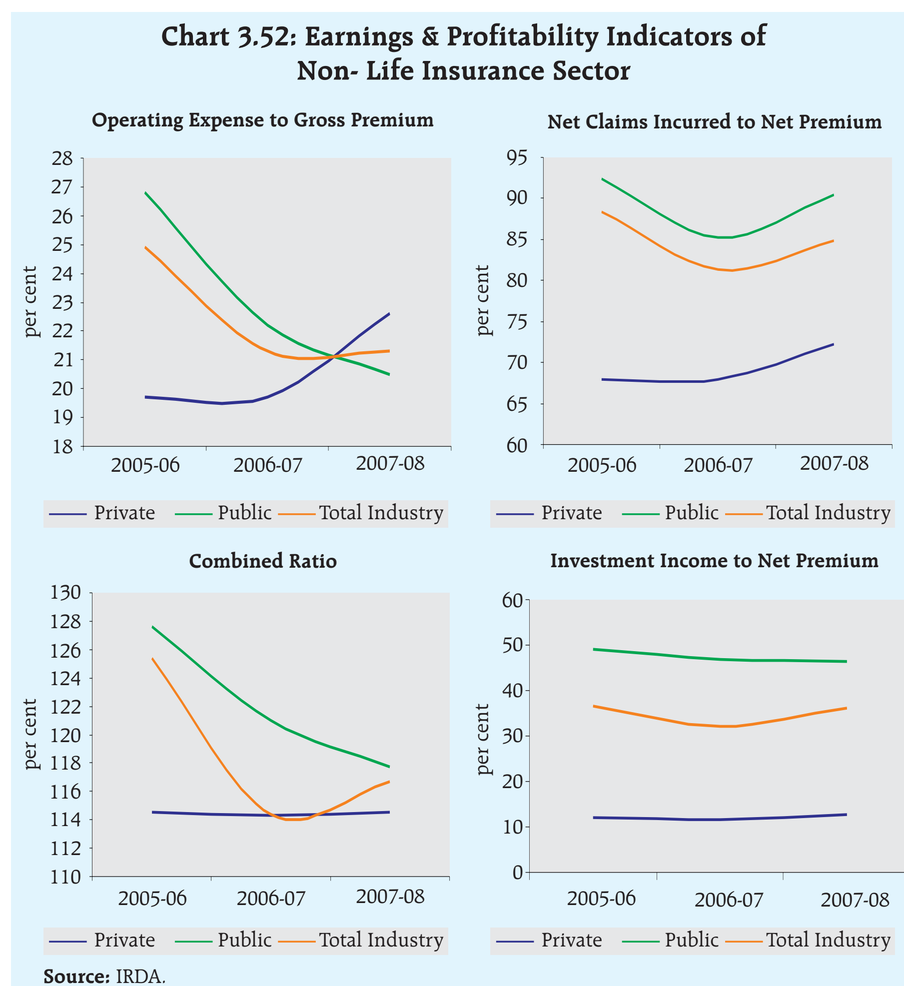
*Earnings and Profitability*

Operating expenses to gross premium has shown a general decline in recent years. However, the high ratio of net claims to net premiums particularly in public sector companies raises concerns. This calls for better quality control in underwriting new business, better risk management and appropriate utilisation of reinsurance. The adequacy of premium, particularly in respect of public sector companies, needs to be looked into. The combined ratio, which takes into account both loss ratio and expenses incurred, is more than 100 per cent, which indicates potential vulnerability. The ratio of investment income to net premium shows that the public sector companies have larger investment assets than their private sector counterparts (Chart 3.52).

*Liquidity*

The liquidity position, as indicated by the ratio of current assets to current liabilities, at around 60 per cent indicates its inadequacy, as current assets are not sufficient to cover all current liabilities (Chart 3.53).

There is a scope for improvement in the earnings and profitability as well as liquidity ratios of the non-life sector.

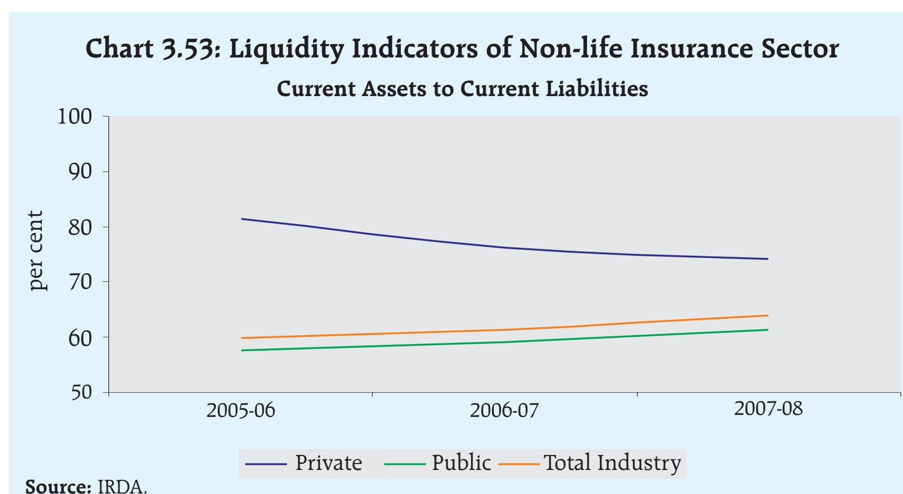



**Source:** IRDA.

### 3.7.2 Resilience

It was felt that stress tests for the non-life sector would be more meaningful after detariffing of the sector. Consequently, the stress tests carried out in the assessment are entirely for the life insurance companies. The 'bottom-up' approach has been recommended for carrying out stress tests in the life insurance sector.

The main shock variables in the Indian context can be viewed as market-specific and insurance-specific. The former mainly includes interest rate risk and equity price risk. Mortality risk, expense risk and persistency risk may be included under insurance-specific risk variables, though market conditions impact persistency. The above shock variables have been adopted keeping in



**Source:** IRDA.

view of the environment in which the sector is working and the risks which are envisaged in this environment, The sensitivity of statutory solvency ratio (150 per cent) has been quantified for two typical life offices that are christened Life Office-A and Life Office-B with exactly the reverse types of business portfolios; Life Office A has 90 per cent of its portfolio in unit-linked business, whereas only 6.3 per cent of Life Office B's business is in linked products as at March 31, 2007. The details of the stress test results are tabulated below (Table 3.29):

**Table 3.29: Stress Test Results**

| Shock Variable | Size of the shock ( per cent) | Effect on Life Office-A | Effect on Life Office-B |
|---|---|---|---|
| Equity price | Drop by 25 | Not Significant | Not Significant |
| Interest rate | Drop by 2 | SR drops to 129 | SR drops to 119 |
| Mortality experience | Increase by 20 | SR drops to 148 | SR drops to 139 |
| Expense experience | Increase by 20 | SR drops to 115 | SR drops to 134 |
| Withdrawal experience | Increase by 20 | Slightly improved | Slightly improved |

**Source:** IRDA

While the equity shock does not impact the solvency ratios of the companies significantly, increase in withdrawal experience results in improvement of solvency ratios as the release of reserves in these cases outweighs the reduction in assets associated with withdrawals. The solvency ratio is very sensitive to interest rate and expense variation, and the impact is more significant in respect of Life Office B which has a higher dependence on non-linked business. Mortality experience does not have a very significant impact on these life offices.

### 3.7.3 Assessment of Adherence to Insurance Core Principles (ICPs)

### 3.7.31 Benchmark- Insurance Core Principles

The International Association of Insurance Supervisors (IAIS) developed the Insurance Core Principles (ICPs) in 2000 as the key global standards for prudential regulation and supervision of the insurance sector across jurisdictions. There are 28 ICPs which are broadly grouped into seven

categories. Each principle is elaborated through essential and advanced criteria. Based on the assessment of the criteria, each principle is assessed as Observed, Largely observed, Partly observed and Not observed (Box 3.6).

**3.7.32 Earlier Assessments**

Adherence to IAIS Core Principles in respect of insurance companies was assessed earlier as part of the self-assessment of standards and codes by the Standing Committee on International Financial Standards and Codes in 2002 and by a Review Committee in 2004. The major gaps identified by the earlier assessments that are yet to be addressed relate to co-ordination between regulators and amendment of the Insurance Act to enable insurance companies to provide allied services to customers.

**3.7.33 Present Assessment**

The status of compliance to IAIS principles in respect of insurance companies as assessed by the Advisory Panel is summarised in Table 3.30.

The assessment of ICPs was reviewed by Mr. Carl Hiralal and Mr. Michael Hafeman. Mr. Hiralal suggested changes in the assessment of some principles, based on the information given in the assessment of principles.

Mr. Hafeman stated that it is evident that both the insurance sector in India and the Insurance Regulatory and Development Agency (IRDA) have made great progress in recent years. The initiative that India has taken to prepare the assessments of observance of international standards demonstrates a strong commitment to making further progress. He suggested a need to provide more information on some of the assessment of principles and to change the assessment of some principles. The changes were suggested in areas relating to supervisory co-operation and information sharing, licensing and enforcement/sanctions.

The Advisory Panel on Financial Regulation and Supervision took cognisance of the peer reviewers' suggestions and appropriately revised the assessment.

The overall assessment shows that the number of principles which are observed are 5, largely observed are 13 and partly observed are 10.

The regulatory framework for insurance supervision is placed against the background of the statutory framework which encompasses the legislative, regulatory and institutional framework, both for the financial

### Box 3.6: Insurance Core Principles

Insurance Core Principles provide a globally accepted framework for the regulation and supervision of the insurance sector. The principles apply to supervision of insurers and reinsurers, whether private or government controlled insurers that compete with private insurers wherever their business is conducted including through e-commerce. The 28 Insurance Core Principles can be grouped into seven broad categories which are enumerated below:

**Category I: Conditions for effective supervision**

ICP1: Includes broad requirements in financial policy and financial market infrastructure to support effective supervision

**Category II: Mandates and responsibilities of supervisor**

ICP2: Supervisory objectives seek clarity in law

ICP3: Supervisory authority seeks adequate powers, resources and legal protection

ICP4: Supervisory process seeks transparency and accountability

ICP5: Deals with co-operation and information sharing mechanisms within the insurance sector and across the financial sector

**Category III: Form and governance of insurers**

ICP6: Deals with licensing requirements which should be clear, objective and public

ICP7: Deals with suitability of persons and requires ongoing assessment of fitness and propriety of significant owners and key functionaries

ICP8: Deals with changes in control and portfolio transfers requiring supervisory approval

ICP9: Corporate governance requires prudent management of an insurer's business on basis of standards that stress role of board and senior management

ICP10: Deals with internal control systems including internal audit and reporting as well as compliance function

**Category IV: Ongoing supervision**

ICP11: Market analysis requires macroprudential surveillance of sector

ICP12: Deals with reporting to supervisors and require reporting that is done on solo and a group basis

ICP13: Deals with on-site inspection which requires comprehensive powers for both insurer and outsourced companies

ICP14: Deals with preventive and corrective measures which require an adequate, timely and graduated spectrum of remedial measures

ICP15: Deals with enforcement or sanctions that will require measures that are based on clear objective criteria

ICP16: Deals with winding up and exit from market which require criteria and procedure for insolvency

ICP17: Deals with group-wide supervision

**Category V: Prudential requirements**

ICP18: Deals with risk managements and their review by supervision

ICP19: Deals with strategic underwriting and pricing policies as well as limits on risk retained through reinsurance

ICP20: Liabilities specify supervisory requirements to assess adequacy of technical provisions held against policy liabilities

ICP21: Investments require compliance with standards on investment policy, asset mix, valuation, risk management and asset liability management

ICP22: Derivatives and similar commitments cover restrictions on their use and on requirements for disclosures

ICP23: (capital adequacy and solvency) Covers sufficiency of technical provisions to cover expected claims and expenses

**Category VI: Distribution, customer protections, disclosure and fraud**

ICP24: Intermediaries cover licensing and business requirements for insurance intermediaries

ICP25: Consumer protection covers requirements on providing of information to consumers before and during a contract

ICP26: Information, disclosure and transparency towards market call for adequate disclosure by insurance firms

ICP27: Frauds call for measures to prevent, detect and remedy insurance fraud

**Category VII: Anti-Money Laundering**

ICP28: AML-CFT requires effective measures to detect, deter and report AML-CFT offences

**Source:** International Association of Insurance Supervisors, October 2003.

sector and the economy at large. It provides enough flexibility to keep the current practices up to date to meet industry needs. The legislative framework for the insurance sector is contained in the Insurance Act, 1938 and the IRDA Act, 1999. In addition to the statutory framework as laid down under the Acts of Parliament, the IRDA notifies regulations covering specific areas of operations of insurance companies. Although the legislation vests the IRDA with the powers to enforce the observance of the law and regulations framed for effective discharge of its supervisory responsibilities, some of the powers still rest with the Government. In addition, there are some exempted insurers who do not come under the purview of the supervision of IRDA. The IRDA interacts with other international supervisors/supervisors of other jurisdictions to draw upon their experiences on regulatory supervision or to gain insights on issues which do not have precedence in the host country. It considers and issues the certificate of registration to insurance companies. The IRDA approves the shareholding pattern at the time of grant of registration to an insurance company. It analyses the performance of insurance companies on a monthly, quarterly and annual basis, based on business figures and other parameters furnished by the life and general insurers. On-site inspections have been carried out by the IRDA for the purpose of focused/specific inspections – targeted exams focus on operational areas of an insurance company, such as business procurement, policy

Some of the powers pertaining to supervision which still rest with the Government need to be transferred to the IRDA.

| Sr. No. | Principle | Status of Compliance |
|---|---|---|
| | **Conditions for effective supervision** | |
| 1. | Conditions for effective insurance supervision | LO |
| | **Responsibilities of supervisor** | |
| 2. | Supervisory objectives | LO |
| 3. | Supervisory authority | LO |
| 4. | Supervisory process | LO |
| 5. | Supervisory co-operation and information sharing | LO |
| | **Form and governance of insurers** | |
| 6. | Licensing | LO |
| 7. | Suitability of persons | LO |
| 8. | Changes in control and portfolio transfers | O |
| 9. | Corporate governance | PO |
| 10. | Internal control | PO |
| | **Ongoing supervision** | |
| 11. | Market analysis | PO |
| 12. | Reporting to supervisors and off-site monitoring | LO |
| 13. | On-site inspection | LO |
| 14. | Preventive and corrective measures | LO |
| 15. | Enforcement or sanctions | PO |
| 16. | Winding-up and exit from the market | PO |
| 17. | Group-wide supervision | PO |
| | **Prudential requirements** | |
| 18. | Risk assessment and management | PO |
| 19. | Insurance activity | PO |
| 20. | Liabilities | O |
| 21. | Investments | LO |
| 22. | Derivatives and similar commitments | PO |
| 23. | Capital adequacy and solvency | O |
| | **Distribution, consumer protection, disclosures and fraud** | |
| 24. | Intermediaries | O |
| 25. | Consumer protection | O |
| 26. | Information, disclosure & transparency towards the market | LO |
| 27. | Fraud | PO |
| | **Anti-Money laundering** | |
| 28. | Anti-money laundering, combating the financing of terrorism (AML/CFT) | LO |

Table 3.30: Summary Assessment of Insurance Core Principles

O-Observed, LO-Largely observed, PO-Partly observed, NO-Not observed

**Source :** Advisory Panel on Financial Regulation and Supervision.

issuance, claims settlement and other servicing aspects of the insurance business. Financial/comprehensive inspections are proposed to be undertaken as the next step in this direction. The IRDA can suspend or cancel the license of insurers and insurance intermediaries, besides imposing monetary penalties. The gaps in assessment are in areas of corporate governance, internal control, group-wide supervision, risk assessment and management and derivatives and similar commitments.

Mr. Michael Hafeman and Mr. Carl Hiralal, the peer reviewers, had suggested revising the assessment of some principles such as Principle 2 relating to supervisory objectives, Principle 4 relating to supervisory process, Principle 6 relating to licensing, Principle 7 relating to suitability of persons and Principle 15 relating to enforcement of sanctions. Some of these revisions

were accepted by the Panel. The peer reviewers had also suggested furnishing further information on the assessments, which has been incorporated by the Panel in their assessments.

With a view to achieve convergence to IAIS Core Principles in areas where gaps have been observed, the Advisory Panel had made appropriate recommendations. The CFSA endorses the view of the Advisory Panel and believes that the views which are summarised below could be considered:

*Amendments to legislative framework for effective insurance supervision*

Some provisions of the Insurance Act, 1938 are outdated and need to be reviewed in the context of the changing economic environment. The Panel noted that the proposals for amendments to the Insurance Act, 1938 and the LIC Act, 1956 have since been forwarded by the IRDA to the Government. The CFSA notes that the Insurance Laws Amendment Bill, 2008 and the Life Insurance Corporation (Amendment) Bill, 2008 has also been introduced in Parliament.

*Strengthening the Powers Vested with IRDA*

Some powers pertaining to supervision which still rest with the Government, such as the constitution of a consultative committee, the enforcement of criminal penalties and in matters of winding up an insurance company need to be transferred to the IRDA.

As the regulatory position with respect to exempted insurers is not clear, a roadmap needs to be laid down by the Government/IRDA for the continuance or otherwise of these entities to address concerns relating to the protection of policyholders.

The CFSA notes that the Insurance Laws Amendment Bill, 2008 which would take care of these concerns has been introduced in Parliament.

*Specific Provisos Applicable to state-owned Insurance Companies:*

Government-owned insurers continue to be governed by certain provisions of specific legislations (that regulate their activities), apart from the insurance legislation governing the industry. This dichotomy goes against the basic premise of a level playing field for all entities operating in the sector. It is a deterrent to effective supervision. The proposed amendments by the IRDA sent to the Government would address these concerns.

The CFSA notes that the Insurance Laws Amendment Bill, 2008 and Life Insurance Corporation Act, which seek to bring amendments in the General

Insurance Business (Nationalisation) Act, 1972, Insurance Act, 1938, IRDA Act, 1999 and amendments to Life Insurance Corporation Act, 1956 aim at bringing the state-owned specific legislations in line with the Insurance Act and IRDA Act.

*Corporate Governance Framework*

Though the IRDA has not laid down any corporate governance framework, insurance companies have to comply with the stipulations laid down in the general corporate laws. Further, though none of the insurance companies are listed at present, post-listing, the stipulations on corporate governance as provided by the securities market regulator would also become applicable to them. A comprehensive set of guidelines, given the specific requirements of the insurance sector, is however required. The Panel noted that the IRDA has taken the initiative to put in place a corporate governance framework.

The IRDA reviews the methodology adopted by insurance companies to set premium rates and also assumes that adequate systems are in place for risk transfer arrangements that are consistent with the overall capital position. While the regulatory requirement for the underwriting policy being approved by the respective Boards of the companies is in place in the case of general insurance companies, the same needs to be extended to life insurance companies.

The regulatory framework does not stipulate that in case the insurer is aware of instances where the fitness and propriety of its key functionaries is in question (particularly where criminal charges have been framed), it should inform the IRDA about the same. The IRDA is yet to lay down the guidelines on reporting of 'fit and proper' compliance applicable to members of the Board and to key management functionaries. These stipulations, when framed, would form part of the corporate governance framework.

The IRDA reviews the 'internal controls and checks' at the offices of insurance companies, as part of on-site inspection. In addition, it relies upon the certifications which form part of the Management Report, confirming that an internal audit system has been put in place commensurate with the size and nature of its business and that it is operating effectively. In this connection, the appointed actuary has been assigned a significant role and is a significant link between the IRDA and the regulated entity. As there are no formal stipulations from the IRDA on internal controls, these need to be formalised as part of the corporate governance framework.

The IRDA is yet to lay down guidelines on reporting of 'fit and proper' compliance.

*Supervisory Framework*

The IRDA is taking steps to build a database to enable it to conduct market analysis. Concerted efforts are being made by the IRDA, the Self Regulatory Organisations (SROs) and the insurance companies in this direction. Systems have to be put in place to facilitate the development of early warning signals and taking policy-level decisions.

Under the Insurance Act, every company registered to carry on an insurance business is regulated on a stand-alone basis and not on a group basis, even if the insurer belongs to a group as defined under company law. Though definition of what constitutes an insurance group and financial conglomerate and its supervision is not laid down under insurance law, monitoring the performance of the financial conglomerates is done through processes established among regulators in the financial sector. For the present, this is being is done on the basis of inter-regulatory coordination and not on a stand-alone basis. The legislation also does not vest the IRDA with requisite powers to ensure protection of an insurance company in case the group to which it belongs encounters financial difficulties. Systems need to be put in place to ensure effective group-wide supervision. This would also require co-operation and interaction between various regulators, both within the financial sector and outside. To formalise the systems, the legislation needs to provide for entering into Memoranda of Understanding between both the home and foreign regulators.

*Framework for Preventive and Corrective Measures*

The IRDA is vested with powers to suspend or cancel the license of insurers and insurance intermediaries, besides imposing monetary penalties. However, a formal preventive and corrective action framework needs to be put in place.

*Issues relating to Financial Prudence by the Insurance Companies:*

Although the regulatory framework provides for the manner of distribution of surpluses in the case of life companies, the IRDA does not have the necessary powers to direct the suspension of dividends to shareholders in the case of general insurance companies under adverse conditions. However general insurance companies are required to comply with the provisions of corporate laws. On lines similar to the banking sector, prudent guidelines need to be put in place to ensure that earnings are retained within the insurance companies under specified circumstances, including underwriting losses.

*Framework for Risk Assessment and Management*

Though specific regulations or tools have not been prescribed for the insurers on risk assessment and risk management, periodic reports, like actuarial reports and annual reports that are submitted to the IRDA, provide the framework which enables insurers to assess internally the risks faced by

Systems need to be put in place to ensure effective group-wide supervision.

them and to state the strategies to manage the same. There is, however, a need for setting up comprehensive risk management systems in the offices of insurance companies, which is proposed to be stipulated as part of the overall corporate governance framework. There is also a requirement to put in place the stipulation for setting up a Risk Management Committee.

Comprehensive risk management systems need to be set up.

Insurers are required to submit a copy of all reinsurance arrangements made with the re-insurers to the IRDA. Any deviation or abnormality identified at the IRDA end is required to be immediately addressed. There is a need for further clarity on the manner of accounting of the risk transfer mechanisms.

Currently, the IRDA has allowed limited use of derivatives in relation to management of risk relating to movements in interest rates. It proposes to broaden the scope of use of derivatives by the industry in a phased manner, based on the experience gained. This is particularly so since the industry has not started taking any exposure in respect of the avenues already available under the regulatory framework. Interest rate derivatives have been permitted by the IRDA as a hedging instrument; however, insurance companies have not yet made use of this option. As part of overall risk management procedures, the IRDA needs to address issues related to the policy framework that needs to be put in place for risks associated with dealing in derivatives by insurance companies.

There is need for further clarity on the manner of accounting of risk transfer mechanisms.

*Framework for Detection of Fraud*

The legislation vests the IRDA with the power to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policyholders or in a manner prejudicial to the interests of the insurer; or generally to secure the proper management of any insurer. The regulations have been framed to ensure the protection of policyholders which, *inter alia,* lay down prescriptions relating to market conduct of an insurer/intermediary. The IRDA has further issued guidelines as and when the situation warrants on the market conduct activities of insurers or intermediaries to check possible insurance frauds. There are, however, no specific requirements at present on the allocation of resources by the insurance companies to combat fraud. This needs to be addressed. Similarly, stipulations need to be put in place on reporting the same to the IRDA once these are detected.

*Enforcement Powers with respect to AML/CFT*

The IRDA has issued guidelines on the anti-money laundering/ combating the financing of terrorism (AML/CFT) programme for both life and general insurers. However, the enforcement powers as required by the applicable legislation are not in place. This is required to be provided for in the legislation governing the IRDA.

The IRDA needs to lay down a framework for dealing with risks arising from derivatives.

*Dissemination of Information to a Wider Cross-section:*

The IRDA could consider some stipulations for more effective dissemination of information on the financial performance of insurance

companies through other accessible media. This will provide transparency on the operations of insurance companies.

### 3.7.4 Issues and Concerns

The assessments of insurance companies were undertaken from two standpoints. The Panel on Financial Stability and Stress Testing assessed the performance and resilience of the insurance companies, while the Panel on Financial Regulation and Supervision assessed the regulatory structure with respect to the insurance sector. The CFSA is generally in agreement with the issues and recommendations of the Panels, which are listed below. In one or two cases where the Panels held a divergent view, the CFSA has elaborated its stand on the matter.

#### 3.7.41 Limitations on Stress Testing

The stress testing of the insurance sector is constrained by a multitude of factors, the primary ones being:

i) Availability of adequate data.

ii) Heterogeneity of the insurance sector in terms of business size, risk exposure and age of individual companies with different expansion paths.

iii) Lack of adequate disclosures in the financial statements.

iv) Difficulties in revaluation of liabilities in the insurance balance sheets.

The Panel on Financial Stability Assessment and Stress Testing observed that both regulators and companies need to develop a system to ensure data availability on a satisfactory basis and update it on a continuous basis. The CFSA concurs with the Panel's recommendation.

#### 3.7.42 Expense Management

The stress test results show that the solvency ratios of life insurance companies are impacted significantly in the event of administering an expense shock. The expense ratios in the case of non-life companies are also not very healthy. Indian insurance companies currently are an emerging sector which is developing at a rapid pace and would need to continue its momentum, at least in the medium term. To increase their market share, companies are increasingly enhancing their branch networks and also trying

to access the market through other innovative distribution channels. This comes at a cost. In respect of life insurance, over 50 per cent of their expenses go towards development/capital costs. The Panel on Financial Stability Assessment and Stress Testing observed that companies need to pay more attention to expense management, and recommended the development of appropriate and timely MIS in this regard. The CFSA concurs with the views of the Panel.

Companies need to pay more attention to expense management.

**3.7.43 Asset Liability Management Framework**

The Panel on Financial Stability Assessment and Stress Testing observed that it is important for insurance companies to put in place an asset-liability management (ALM) framework in order to measure and manage market risk and interest rate risk, which can have a pronounced impact on their financial stability – particularly for life insurance companies which have significant levels of non-linked business. Given the long-term nature of assets, particularly in the life insurance industry, the CFSA recommends that there should be appropriate asset-liability management guidelines in place for insurance companies.

**3.7.44 Legislative Amendments**

The process of amendments to the legislative framework governing the insurance sector is already underway. The recommendations made by the IRDA for consideration by the Government were endorsed in this regard. It is pointed out that of the recommendations made, the ones on the autonomy of the IRDA, strengthening the supervisory processes through sanctions and enforcements and the ability of the IRDA to levy penalties directly in proportion to the materiality of non-compliances require to be strengthened. The CFSA feels that legislative reforms for enhancing the powers of the IRDA need to be considered in the interests of financial stability.

**3.7.45 Development of effective Supervisory Framework**

Having built a foundation for insurance companies to start operations on a level playing field, the next critical phase is robust supervision. The Panel on Financial Regulation and Supervision noted that the IRDA is putting in place systems to develop early warning systems to initiate actions where required, and to have the requisite market-wide database to take policy-level decisions. Initiatives are also being taken to strengthen the regulator's office to enable it to discharge its responsibilities effectively.

The Panel on Financial Regulation and Supervision noted that while the IRDA has initiated a number of measures to increase and empower its own manpower to discharge its functions in the rapidly expanding insurance sector, several new issues need to be addressed. There is, thus, a continuing need to enhance the skill-sets of IRDA staff. Similarly, there are issues related to retention of skilled staff**.** While, globally, regulators are unable to match their remuneration structure with those at industry levels, within the IRDA's

There should be appropriate asset-liability management guidelines in place for insurance companies.

office there is still scope for improvement in the remuneration structure for the overall organisation, including at the top management levels. The CFSA believes that IRDA's salary structure should be market related.

**3.7.46 Risk- based Supervision**

The current stipulations are conventional, with stipulations for entry-level minimum capital requirements and maintenance of solvency at 150 per cent of the required solvency. The Panel on Financial Regulation and Supervision observed that initiatives to move towards the more sophisticated Risk-based Capital (RBC) model and Risk-based Supervision (RBS) would require changes in (i) the statute, and (ii) the overall approach towards supervision.

The Panel further observed that, in the context of the Supervisor's office, there would be a need for upgrading supervisory skills to put in place the supervisory framework and to develop skills to assess operational risks and to evolve benchmarks on capital adequacy and solvency. It goes on to state that, while RBS as the underlying principle for supervision pre-supposes the existence of a large number of entities which are required to be supervised and availability of resources in terms of trained manpower at the supervisor's office need to be prioritised, this is not the position in the Indian context. While initiatives are required in this direction, given the present stage of development of the sector and the number of players in the industry, these are not a hindrance to supervision in the present scenario.

The Panel on Financial Stability Assessment and Stress Testing is of the view that, in spite of the hindrances mentioned above, it would still be beneficial to decide on the supervisory cycles/intensity of supervision based on the individual institution's risk profile. A precondition for introduction of RBS would be the development of an adequate database through the introduction of a robust and risk-focused off-site surveillance and monitoring mechanism.

The approach towards adopting risk-based supervision requires to be calibrated, keeping in view ground realities.

The CFSA feels that the approach towards adopting risk-based supervision needs to be calibrated, keeping in view ground realities. At the first stage, the IRDA can look towards the introduction of risk-based capital requirement for the insurance sector. On successful implementation of the same, the IRDA can progress towards adopting a risk-based supervisory cycle for insurance companies.

### 3.7.47 Capacity Building in the Insurance Sector

Insurance companies invest significantly in long-term assets. The equity portfolio of these entities is also significant. The Panel on Financial Stability Assessment and Stress Testing observes that it is essential in this context that the treasury function also acquires investment management skills. As many life insurance companies have entered into joint ventures with banks, it could be appropriate for the insurance ventures to acquire the skill-sets from bank treasuries. However, the mandated investment requirements of the insurance sector (approximately 65 per cent of total investments), where a very significant portion of the insurance funds are to be placed in low-risk, low-yield securities, to some extent act as a disincentive for the companies to develop their treasury functions. It may be expected that as the country develops and incomes grow, the risk appetite of people will also grow. In this context, the need to revise investment guidelines will also progressively evolve.

The Panel also noted that the Indian insurance industry faces a practical problem arising from inadequate supply of specialised skilled professionals, particularly in the areas of actuarial and underwriting skills in non-traditional areas. Although the actuarial profession is growing at a significant pace and the field is experiencing an inflow from other professions, the impact of the significant gap in supply and demand of actuarial professionals is being felt by the industry. It will take another three to four years to bridge the gap between demand and supply.

The CFSA is in agreement with the views expressed by the Panel and feels that adequate initiatives need to be taken for skill development in the insurance industry.

### 3.7.48 Regulatory Co-operation

During the initial phase of growth of the insurance sector, Unit Linked Insurance Plans (ULIPs) were seen as somewhat analogous to equity linked savings schemes (ELSS) and similar mutual fund schemes. ULIPs are issued by insurance companies (regulated by the IRDA), whereas mutual fund schemes are issued by mutual funds (regulated by SEBI). Insurance companies and mutual funds operate under different regulatory regimes with separate prudential norms. New guidelines issued by the IRDA in 2006 have stopped ULIPs from being positioned as a short-term investment product. In order to ensure that these two different savings instruments with short- and long-term investment objectives are positioned appropriately to reflect their respective positions, steps are being taken towards inter-regulatory co-operation on an ongoing basis. The CFSA concurs with the view and notes that the issues relating to inter-regulatory co-operation have been examined in greater detail in the section on regulatory structure. Going forward the CFSA feels that better inter-regulatory co-operation would assume further importance to effectively address regulatory arbitrage issues relating to derivative products like CDOs.

Adequate initiatives need to be taken for skill development in the insurance industry.

### 3.7.5 Summary

Consequent to the enactment of the Insurance Regulatory and Development Authority Act in 1999, the insurance sector was opened to private participation. The concentration in the life insurance sector still remains high. The post-deregulation period has seen further diversification in insurance product offerings, with added stress on marketing and distribution strategies. The size of the insurance business also has been increasing in both the life insurance and non-life insurance segments. There has also been an increase in insurance penetration. Participation of foreign joint venture partners through the FDI route is limited to the extent of 26 per cent of the paid-up capital; proposals are being considered to increase this FDI cap to 49 per cent. Though in the immediate future this would have difficulties owing to the global financial turmoil and the absence of enabling statutory framework, this needs to be addressed in the medium term. Regulatory policy has taken a cautious and calibrated approach in sequencing various elements of the reform process, which aims not only at a level playing field, but also takes into account structural constraints in the insurance sector.

An analysis of key indicators for financial soundness shows that the life insurance segment is reasonably comfortable as regards solvency, though the solvency ratio of the largest life insurance company (LIC) is barely at the stipulated regulatory minimum. Capital adequacy, due to low capital base of LIC, is low. Though there has been increase in asset quality ratios, they are within the regulatory stipulation. Profitability and liquidity indicators do not throw up any cause for concern. There is a general trend to increase link-based business in the life sector.

The non-life segment also displays comfortable solvency. The capital base of private non-life sector shows a declining trend. There are, also, some concerns in relation to actuarial issues of the public sector. There are also concerns on the earnings and profitability front, which point to the need for better quality control in underwriting new business, better risk management and increasing reinsurance. The adequacy of premium, particularly in public sector companies, also needs to be looked into. There are some liquidity concerns in the non-life insurance sector, as current assets are not sufficient to cover all current liabilities.

The stress tests carried out for two life insurance companies with diverse business models revealed that as on March 31, 2007 while the equity shock does not impact the solvency ratios of the companies significantly, increase in withdrawal experience results in improvement of solvency ratios

as the release of reserves in these cases outweighs the reduction in assets associated with withdrawals. The solvency ratio is very sensitive to interest rate and expense variation, and the impact is more significant with respect to life office which has a higher dependence on non-linked business. Mortality experience does not have a very significant impact on life offices.

The assessment of Insurance Core Principles reveals that there are gaps in assessment in areas of corporate governance, internal control, group-wide supervision, risk assessment and management and derivatives and similar commitment. The major issues/recommendations arising from the assessment are:

i) As some of the provisions of the Insurance Act, 1938 are outdated, requisite amendments to various Acts have since been forwarded by the IRDA to the Government. The IRDA has also sent proposals to the Government to address issues related to the dichotomy arising from certain provisions of specific legislations as applicable to government owned insurers apart from the insurance legislation governing the industry.

ii) There is a need to increase the supervisory powers of the IRDA by vesting it with requisite powers as regards the constitution of a consultative committee, the enforcement of criminal penalties and winding up of an insurance company.

iii) A roadmap needs to be laid down by the Government/IRDA for the continuance or otherwise of exempted insurers to address concerns related to the protection of the interests of policyholders covered by them.

iv) The IRDA has taken the initiative to put in place a corporate governance framework to cover aspects related to fit-and-proper criteria for Board members, comprehensive risk management guidelines and internal controls and checks.

v) The regulatory requirement for the underwriting policy being approved by the respective Boards of the companies needs to be extended to life insurance companies as well, in line with the practices followed in general insurance companies.

vi) Systems need to be put in place to ensure effective group-wide supervision which would require formalising the relationship through Memoranda of Understanding between both the home and foreign regulators.

vii) A formal preventive and corrective action framework for fraud needs to be put in place.

viii) Prudential guidelines need to be put in place to ensure that earnings are retained within the insurance companies under specified circumstances.

ix) The IRDA should address issues related to the policy framework that need to be put in place for risks associated with dealing in derivatives by insurance companies.

The Insurance Laws Amendment Bill, 2008 and Life Insurance Amendment Bill, 2008 have been introduced in the Parliament.

The stress testing of the insurance sector is constrained by factors like non-availability of adequate data, heterogeneity in the insurance sector, lack of adequate disclosures in financial statements and difficulties in revaluation of liabilities in the balance sheet. There is a requirement for both regulators and companies to develop a system to ensure data availability on a satisfactory basis, and to update it on a continuous basis. As stress tests reveal that life insurance companies are affected significantly in the event of an expense shock, they need to pay attention to expense management and to develop appropriate and timely MIS in this regard. Given the long-term nature of assets, particularly in the life insurance industry, there should be appropriate asset-liability management guidelines in place for insurance companies. There is a continuing need to enhance the skill-sets of IRDA staff, as well as to retain skilled staff. There is a need for IRDA's salary structure to be better aligned with market trends. Life insurance companies need to pay more attention to expense management.

Though initiatives need to be taken to move towards the more sophisticated RBC model and RBS, at the first stage the IRDA can look towards the introduction of risk-based capital requirement for the insurance sector. On successful implementation of the same, the IRDA can progress towards adopting a risk-based supervisory cycle for insurance companies.

The mandated investment requirements of the insurance sector, where a significant portion of the insurance funds is to be placed in low-risk low-yield securities, to some extent act as a disincentive for companies to develop their treasury functions. As the Indian insurance industry faces a practical problem arising from inadequate supply of specialised skilled professionals, particularly in the areas of treasury management and actuarial and underwriting skills in non-traditional areas, adequate initiatives need to be taken in this regard.

## 3.8 Concluding Remarks

Commercial banks have seen an all round improvement in key financial indicators, particularly in areas of capital adequacy, asset quality and earnings.

There has been considerable convergence of financial results and efficiency across bank groups within the sector. Competition within the sector has increased over time as evidenced by the declining share of PSBs and increasing share of NPBs in the banking business. Although it could be argued that a lot of the improvement in the financial health of banks, particularly in the recent years, is a consequence of the buoyant conditions generally prevalent in the economy, the results for the year 2007-08, when the economy has faced some financial strains, do not show any significant worsening and give some degree of comfort about the resilience of commercial banks during the expected financial downturn. Even the financial position for the half year ended September 2008 and for the quarter ending December 2008 reveals that the key financial parameters do not reveal any discernable concerns, though the crisis has resulted in the drying up of capital flows, with its resultant effect on the equity market, and the rupee has depreciated against the US dollar, which has in turn had an impact on overall liquidity in the system.

Though single factor stress testing in areas of credit, interest and liquidity risks shows that the commercial banks are reasonably resilient, it must be pointed out that some improvement is required in the risk mitigation approaches of the banking sector in general with particular reference to liquidity aspects (particularly in view of banks' growing dependence on purchased liquidity) which needs to be focused more both from regulatory as well as internal risk control perspectives. This gains particular significance in the context of the current international experience. Further, the present stress testing exercise has its limitations as it does not take into account correlated risks due to non-availability of data and a model for undertaking such an analysis. There is a need for developing such an analysis over a period of time. There is however, a requirement for improvement in credit appraisal methods and a need to focus on building an appropriate database across the system so that more comprehensive scenario analysis and macro stress testing can be undertaken. The stress testing exercise done with reference to September 2008 also does not reveal any significant cause of concern for the Indian banking system.

Among other things, a stronger banking sector would require more flexibility regarding the approach towards Government ownership of commercial banks, more clarity in the stance towards enhanced presence of foreign banks, a more conducive environment for mergers/amalgamations, improvements in corporate governance and greater focus on capacity building and appropriate executive compensation structure. The ongoing global financial crisis has highlighted the importance of cross-border co-operation.

The financial results of the co-operative banking structure however, show some degree of vulnerability, though they may not be systemically very large. There is a need to address issues relating to governance and Government overlap and interventions in this sector. The regulatory structure also requires a significant overhaul. While MoUs between the

Government and the Reserve Bank/NABARD have been a welcome attempt to circumvent the problems arising out of dual control of regulation of co-operative banks, the progress made in this regard should be continuously monitored so that it evolves with changing circumstances and withstands the test of time. Under the present arrangement, NABARD as well as the Reserve Bank have well-defined roles as far as monitoring of RRBs is concerned. Further, the question of supervision of RRBs was also examined by the Government wherein it was decided to maintain the *status quo*. However, the CFSA feels that as regards supervision of RRBs the recommendations of Sardesai Committee should be considered. Similarly, the task of regulation and supervision of rural co-operatives could be delinked from the Reserve Bank and NABARD and transferred to a separate regulatory authority.

An analysis of the NBFC sector shows that it is the non-deposit taking NBFCs-ND which have become the front-runners in this sector. Given the foray of commercial banks into the NBFC space and the high regulatory compliance norms for deposit taking NBFCs, it needs to be considered whether these entities should be gradually phased out or converted into banks. While the financial performance of the sector has been generally satisfactory, in view of the role of some non-banking financial institutions in the global arena in exacerbating the sub-prime mortgage risk into a global credit crunch, this sector requires close monitoring particularly from the angle of its linkages with other financial institutions and markets. Also, though considerably reduced, there remains some scope for reducing arbitrage opportunities particularly for companies that do not fall within the ambit of any of the regulatory authorities at present, with suitable regulatory changes.

While the housing finance sector has witnessed significant growth in recent years, the share of HFCs in the housing loan market has declined. While the financials of HFCs have shown improvement over time, there are concerns that increased interest rates could elongate loan maturity and lead to loan delinquency. There is also a need for completion of the work relating to a housing price index at the earliest which could facilitate the measurement of loan to value (LTV) ratio which is important for estimating the risk and vulnerability facing the housing finance companies. Further, given the decline in the number of HFCs, as also the major role played by scheduled commercial banks in housing finance, the regulatory role of HFCs could be shifted from NHB (which could continue functioning as development finance institution) and assigned to the Reserve Bank. However, the Government feels that there

is no conflict of interest in combining the development and regulatory roles, as has been done by other agencies like SEBI, IRDA, and TRAI; also, given that the housing market is in its infancy, vesting regulatory and developmental functions with one agency, *viz.*, NHB, would be beneficial for the market. Most HFCs have been facing liquidity problems from October 2008 which has been caused by overall liquidity shortage in the beginning of the year as also increased reliance on short-term market borrowings which during the current year which dried up due to liquidity problems faced by major investors such as mutual funds. Strengthening the financial position of NHB, which is a designated refinancing institution for housing, would partly address the issue of liquidity of HFCs.

The present global financial crisis has revealed the limitations of the Basel Core Principles inasmuch as it does not cover SIVs/NBFCs or aspects like dynamic provisioning and counter cyclical norms as part of the assessment. Hence there is a need to revisit these principles to cover the new areas.

The growth of the insurance sector has been impressive both in the life and non-life segments. Though the concentration in the insurance sector is very high, it shows a declining trend since the sector was opened to private participation. While the financial results are generally satisfactory, there are some concerns relating to profitability and liquidity in the non-life segment. Stress testing of two life insurance companies shows that though shocks in equity price, withdrawal and mortality experience do not have any material effect, the solvency ratios are very sensitive to interest rate and expense variations. Expense management of insurance companies, legislative amendments to increase the autonomy of IRDA (the Insurance Laws Amendment Bill, 2008 and Life Insurance Corporation (Amendment) Bill, 2008 have been introduced in Parliament), development of an effective supervisory framework, introduction of an asset liability framework as also capacity building are some of the major areas that need to be focussed on for development of this sector.

The recent global financial turmoil has brought into sharp focus the liquidity and contagion risks facing the financial institutions. In this context, there is a requirement for an integrated risk management approach which takes into account all facets of risk and their contiguous properties and increased regulatory co-operation and information sharing.

Given the general robustness of the regulatory and supervisory environment complemented by a gradual approach towards financial sector reforms, India has remained relatively less affected by the financial crises which have impacted the international financial system at different points in time from the 1990s till date. The current world financial situation, perhaps, underscores the fact that while there is a need to carry forward the process of strengthening financial sector development, the pros and cons of each step taken in this direction should be carefully evaluated and the pace of the process accordingly determined.

## Annex

### Assessment of BCPs of financial institutions

The Basel Core Principles (BCPs) are meant for the assessment of regulatory and supervisory practices with regard to commercial banks and are not strictly applicable to other financial institutions. Recognising, however, the importance of the other segments, for the purpose of the current exercise the Advisory Panel on Financial Regulation and Supervision chose to extend the assessment to urban co-operative banks, rural financial institutions, non-banking financial companies and housing finance companies. Though urban co-operative banks and rural financial institutions are banks, the BCPs are not applicable to them in the strictest sense; as co-operatives, they have a different organisational structure and function with certain broader socio-economic objectives. The case is similar for non-banking financial companies and housing finance companies. The following sections furnish the details of assessment with respect to urban co-operative banks, State Co-operative Banks and District Central Co-operative Banks, Regional Rural Banks, Non-Banking Financial Companies and Housing Finance Companies.

## Section I

**Assessment of Basel Core Principles: Urban Co-operative Banks (UCBs)**

The Advisory Panel on Financial Regulation and Supervision has observed that some of the Basel Core Principles (BCPs) are not strictly applicable to UCBs, *viz.*, transfer of significant ownership, country and transfer risk, consolidated supervision and home-host relationship. Further, BCPs may not be applicable to a significant proportion of these entities which are very small in size and conduct only rudimentary banking operations. The assessment, therefore, covers only larger and scheduled UCBs with public deposits above Rs.100 crore accounting for 42.3 per cent of the total deposit base of all UCBs. A summary assessment of the Basel Core Principles in respect of UCBs is tabulated below.

Overall, the assessment shows that the number of principles which are compliant are four, largely compliant are 11, materially non-compliant are four and non-compliant are two while four principles are not applicable to UCBs. The assessment shows that the non-compliance and the material non-compliance occur under the category of prudential requirements and risk management principles, pointing to the need for strengthening these two aspects.

| Table 3.31: Summary Assessment of Urban Co-operative Banks | | |
|---|---|---|
| **Sr. No.** | **Principle** | **Status of Compliance** |
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | LC |
| 3. | Licensing criteria | LC |
| 4. | Transfer of significant ownership | NA |
| 5. | Major acquisitions | C |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | C |
| 7. | Risk management process | MNC |
| 8. | Credit risk | LC |
| 9. | Problem assets, provisions and reserves | C |
| 10. | Large exposure limits | LC |
| 11. | Exposure to related parties | C |
| 12. | Country and transfer risk | NA |
| 13. | Market risk | MNC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | NC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | MNC |
| 18. | Abuse of financial services | LC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | LC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | NA |
| 25. | Home-host relationship | NA |

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant, NA – Not Applicable

**Source :** Advisory Panel on Financial Regulation and Supervision.

The assessment revealed that the permissible activities that can be carried out by UCBs are clearly defined. Acquisition by way of mergers requires the prior approval of both the Reserve Bank and the Registrar of Co-operative Societies. The Reserve Bank has issued guidelines on risk management which are mostly confined to credit risk. The Asset Liability Management (ALM) guidelines regarding structural liquidity and interest rate risk are applicable only to scheduled UCBs, *i.e.*, the larger entities. The Reserve Bank has issued capital adequacy guidelines which include both on- and off-balance sheet items. It has issued detailed guidelines on income recognition, asset classification and provisioning. Related parties have been defined and there are clear-cut guidelines in place. The Reserve Bank has issued guidelines to banks asking them to put in place adequate internal controls.

## Section II

### Assessment of Basel Core Principles: Rural Co-operatives

The Panel on Financial Regulation and Supervision felt that given the co-operative structure of State Co-operative Banks and District Central Co-operative Banks and their scale of functioning, the principles relating to transfer of significant ownership, country and transfer risk, consolidated supervision and home-host relationship are not applicable. The status of adherence to Basel Core Principles is summarised below.

**Table 3.32: Summary Assessment of State Co-operative Banks/ District Central Co-operative Banks**

| Sr. No. | Principle | Status of Compliance |
|---|---|---|
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | LC |
| 3. | Licensing criteria | LC |
| 4. | Transfer of significant ownership | NA |
| 5. | Major acquisitions | C |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | MNC |
| 7. | Risk management process | MNC |
| 8. | Credit risk | LC |
| 9. | Problem assets, provisions and reserves | LC |
| 10. | Large exposure limits | C |
| 11. | Exposure to related parties | C |
| 12. | Country and transfer risk | NA |
| 13. | Market risk | MNC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | NC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | MNC |
| 18. | Abuse of financial services | MNC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | LC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | NA |
| 25. | Home-host relationship | NA |

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant
**Source :** Advisory Panel on Financial Regulation and Supervision.

Overall the assessment shows that the number of principles which are compliant are three, largely compliant are 10, materially non-compliant are six, non-compliant are two and four principles were not applicable. The status of non-compliance and material non-compliance is under the category of prudential requirements and risk management.

There is a suitable legal framework in place which includes provisions related to the licensing of StCBs/DCCBs, the setting of prudential rules and their supervision. Broad guidelines on risk management have been issued to StCBs/DCCBs. Guidelines have been issued to StCBs/DCCBs covering credit management, income recognition, asset classification and provisioning and aspects of internal checks and control systems. The Reserve Bank has recently advised all co-operative banks to indicate the CRAR in their balance sheets as on 31 March, 2008 and thereafter every year as 'Notes on Accounts' to their balance sheets.

## Section III

**Assessment of Basel Core Principles: Regional Rural Banks**

Given the special features of Regional Rural Banks, some of the Basel Core Principles are not strictly applicable to them, *viz.*, licensing criteria, transfer of significant ownership, country and transfer risk, consolidated supervision and home-host relationship. The summary assessment of Basel Core Principles in respect of RRBs is as under:

Overall, the assessment shows that four principles are compliant, eight are largely compliant, six are materially non-compliant and two are non-compliant and five are not applicable. All the non-compliant and materially non-compliant assessments fall under the category of prudential requirements and risk management, pointing to the need for strengthening this aspect.

The assessment revealed that there is a suitable legal framework in place which includes provisions relating to setting prudential rules and ongoing supervision. The permissible activities of institutions that are licensed and subject to supervision are clearly defined. Guidelines to RRBs on income recognition, assets classification and provisioning have been issued. The RRB Act, 1976 clearly provides for duties and responsibilities of the Board and top management, which are being followed by the RRBs. NABARD monitors RRBs through on-site inspections and off-site surveillance returns.

## Section IV

**Assessment of Basel Core Principles: Non-Banking Financial Companies**

The Advisory Panel limited the scope of assessment to NBFC-D and Non-Banking Financial Company – Non-Deposit Taking – Systemically Important (NBFC-ND-SI) which are being monitored rigorously by the Reserve Bank. The regulatory norms for deposit-taking NBFCs have been looked at particularly from the deposit protection angle since such deposits are not covered by

**Table 3.33: Summary Assessment of Regional Rural Banks**

| Sr. No. | Principle | Status of Compliance |
|---|---|---|
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | C |
| 3. | Licensing criteria | NA |
| 4. | Transfer of significant ownership | NA |
| 5. | Major acquisitions | C |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | NC |
| 7. | Risk management process | MNC |
| 8. | Credit risk | C |
| 9. | Problem assets, provisions and reserves | C |
| 10. | Large exposure limits | LC |
| 11. | Exposure to related parties | LC |
| 12. | Country and transfer risk | NA |
| 13. | Market risk | MNC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | MNC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | MNC |
| 18. | Abuse of financial services | MNC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | LC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | NA |
| 25. | Home-host relationship | NA |

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant
**Source :** Advisory Panel on Financial Regulation and Supervision.

insurance. As per the current policy, some of the fast-growing NBFCs that are diversifying into riskier businesses are required to unwind their portfolio within a specific timeframe. The status of adherence to Basel Core Principles is summarised below.

Overall, the assessment shows that the number of principles that are compliant is one, largely compliant are 13, materially non-compliant are two, non-compliant are eight and one is not applicable. The assessment has

revealed that there are several gaps in areas relating to home-host co-operation, transfer of significant ownership, major acquisitions, exposure to related parties, market, liquidity and operational risk, internal control and interest rate risk in the banking book.

The assessment revealed that the Reserve Bank which regulates and supervises NBFCs has clear responsibilities and objectives and possesses transparent processes, sound governance and adequate resources. Statutes, including provisions related to the licensing of NBFCs, setting prudential rules and their ongoing supervision are in place. The fit and proper test in the form of due diligence is carried out for directors only. The Reserve Bank has issued guidelines on capital adequacy which include both on- and off-balance sheet items and are applicable to both NBFCs-D and NBFCs-ND-SI. It has issued guidelines to NBFCs with respect to credit risk management. There are regulatory norms for management of problem assets of provisions and reserves. The Reserve Bank has issued guidelines to NBFCs to put in place adequate internal controls. The Reserve Bank conducts both on-site and off-site supervision of NBFCs which is limited to NBFCs-D and NBFCs-ND-SI.

**Table 3.34: Summary Assessment of Non-Banking Financial Companies**

| Sr. No. | Principle | Status of Compliance |
|---|---|---|
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | LC |
| 3. | Licensing criteria | LC |
| 4. | Transfer of significant ownership | NC |
| 5. | Major acquisitions | NC |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | C |
| 7. | Risk management process | LC |
| 8. | Credit risk | LC |
| 9. | Problem assets, provisions and reserves | LC |
| 10. | Large exposure limits | LC |
| 11. | Exposure to related parties | NC |
| 12. | Country and transfer risk | NA |
| 13. | Market risk | NC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | NC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | MNC |
| 18. | Abuse of financial services | LC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | LC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | NC |
| 25. | Home-host relationship | NC |

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant
**Source :** Advisory Panel on Financial Regulation and Supervision.

## Section V

### Assessment of Basel Core Principles: Housing Finance Companies

Overall, the assessment shows that the number of principles which are compliant are two, largely compliant are 10, materially non-compliant are five and non-compliant are eight.

The assessment reveals that there is a suitable legal framework in place which includes provisions relating to the licensing of HFCs, setting prudential rules and their ongoing supervision, empowering supervisors to address compliance with laws to ensure safety and soundness of HFCs, supervisors to have access to HFCs' Board and management, and to take action against banks indulging in unsound practices. The NHB is empowered to set criteria for licensing HFCs. It also has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate. The NHB carries out fit and proper tests for promoters and senior management. The NHB has issued guidelines on capital adequacy, which include both on- and off-balance sheet items that are uniformly applicable to all players in the housing finance sector. The NHB satisfies itself that HFCs establish and adhere to adequate policies and processes to manage problem assets, and evaluates the adequacy of provisions and reserves. As per current practice, liquidity risk and interest rate risk are reported as a part of ALM returns; however, these ALM guidelines are applicable only to the larger HFCs. The NHB determines whether the HFCs have in place internal controls which include responsibility of the Boards and/or senior management and deal with organisational structure, accounting policies and processes, checks and balances, and safeguarding assets and investments.

The assessment revealed that there were gaps in principles relating to transfer of significant ownership and major acquisitions: home-host co-operation; permissible activities; exposure to related parties; risk management and internal control.

### Conclusion

The CFSA notes that though BCPs are not applicable to the aforesaid entities, the Advisory Panels' efforts to extend the BCP assessment to these sectors are commendable in the current context of the potential impact of such institutions on the stability of the financial system. The Reserve Bank as well as the NHB have been extending some of the prescriptions given to

| Sr. No. | Principle | Status of Compliance |
|---|---|---|
| | **Table 3.35: Summary Assessment of Housing Finance Companies** | |
| | **Objectives, autonomy and resources** | |
| 1. | Objectives independence, powers, transparency and co-operation | LC |
| | **Licensing criteria** | |
| 2. | Permissible activities | MNC |
| 3. | Licensing criteria | LC |
| 4. | Transfer of significant ownership | NC |
| 5. | Major acquisitions | NC |
| | **Prudential requirements and risk management** | |
| 6. | Capital adequacy | C |
| 7. | Risk management process | MNC |
| 8. | Credit risk | LC |
| 9. | Problem assets, provisions and reserves | C |
| 10. | Large exposure limits | LC |
| 11. | Exposure to related parties | MNC |
| 12. | Country and transfer risk | NC |
| 13. | Market risk | NC |
| 14. | Liquidity risk | MNC |
| 15. | Operational risk | NC |
| 16. | Interest rate risk in banking book | NC |
| 17. | Internal control and audit | MNC |
| 18. | Abuse of financial services | LC |
| | **Methods of ongoing supervision** | |
| 19. | Supervisory approach | LC |
| 20. | Supervisory techniques | LC |
| 21. | Supervisory reporting | LC |
| | **Accounting and disclosure** | |
| 22. | Accounting and disclosure | LC |
| | **Corrective and remedial powers** | |
| 23. | Corrective and remedial powers of supervisors | LC |
| | **Consolidated supervision and cross-border banking** | |
| 24. | Consolidated supervision | NC |
| 25. | Home-host relationship | NC |

C- Compliant, LC-Largely Compliant, MNC- Materially Non-Compliant, NC-Non-Compliant

**Source :** Advisory Panel on Financial Regulation and Supervision.

commercial banks to the co-operative sector, NBFCs and HFCs over a period of time. As regards recommendations made by the Panel for convergence of status to BCP, the Reserve Bank and the NHB should closely examine the rationale provided by the Panel, also taking int237237237237o account international best practices where available, and evaluate the necessity of moving into tighter or fresh guidelines from the perspective of systemic stability.

## Chapter IV

# Financial Markets

## 4.1 Introduction

Financial markets in India have seen considerable development since financial sector reforms were initiated in the 1990s. Given the imperatives of the prevailing context, the initial nudge had to be provided through specific policy instruments and actions, but over a period of time these markets have acquired a dynamic of their own. The process of transition in respect of all financial market segments has been largely disruption-free, accommodating the unique features of the existing system while trying to align with the best international practices.

Assessed purely in terms of outcomes, the movement towards achieving the intended objectives of improving the allocative efficiency of resources, ensuring financial stability and maintaining confidence in the financial system by enhancing its soundness and efficiency has been undoubtedly positive. The current situation provides an ideal vantage point for undertaking a review of the process and preparing a guide for future direction.

Indian financial markets can be broadly categorised into the money market, foreign exchange market, government securities market, equity market, corporate bond market and credit market. While equity, government securities, foreign exchange and money markets along with their corresponding derivatives segments have developed into reasonably deep and liquid markets, credit derivatives markets are yet to take off in any significant manner. As regards corporate bonds, while primary issuances have been significant, though concentrated in terms of issuers to public sector financial institutions, these have largely been on a private placement basis and the secondary market has not developed commensurately. The Reserve Bank's Report on Currency and Finance 2005-06, delineates the approaches for making financial markets in India more developed, efficient and integrated in light of the experience gained so far and keeping in view international best practices while recognising the country context.

Financial stability is a key policy objective in emerging markets like India.

| Reserve Bank of India | Securities and Exchange Board of India |
|---|---|
| Money Market & derivatives | Equity Market & derivatives |
| Foreign Exchange Market & derivatives | Corporate Bond Market |
| G-Sec Market & interest rate derivatives | |
| Credit Markets* & derivatives | |

* : With its overall regulatory and supervisory powers over all credit institutions, credit markets come under Reserve Bank regulation.

In an emerging market like India, where the cost of downside risk is very high, the objective of maintaining financial stability has always been kept in view while developing financial markets. Financial intermediaries like banks have also gained from better determination of interest rates in financial markets by pricing their own products better. Moreover, their own risk management has also improved through the availability of different varieties of financial instruments. The access of real sector entities to finance has also been assisted by the appropriate development of the financial market and the availability of transparent information on benchmark interest rates and prevailing exchange rates. Though several reform measures have recently been initiated to develop the financial markets in India, resulting in various segments of the financial market being better developed and integrated, the financial markets need to develop further in line with the evolving financial and economic scenario.

Reforms in the financial markets have encompassed all segments. The development of financial markets in India has been pursued to bring about a transformation in the structure, efficiency and stability of the markets as also to facilitate their integration. The emphasis has been on strengthening price discovery, easing restrictions on flows or transactions, lowering transaction costs, and enhancing liquidity. During the post-reform period, the structure of financial markets has witnessed a significant change in terms of financial instruments traded in various segments of the financial market and market participants. The development of these markets has been done in a calibrated, sequenced and careful manner in step with those in other markets in the real economy. Sequencing has also been informed by the need to develop market infrastructure, technology and the capabilities of market participants and financial institutions in a consistent manner.

Removal of structural bottlenecks and a shift away from administered rates has led to greater domestic integration.

The gradual removal of structural bottlenecks in the Indian financial markets and a shift away from the erstwhile administered rates has led to

greater domestic market integration. This has also benefited from a series of other policy initiatives over time which included enabling market-determined price discovery through interest rate deregulation; expansion and diversification of the investor base; introduction of a variety of instruments of varying features and tenor; and improvement in market infrastructure. Some of the markets which show strong co-movement are money and government securities markets, exchange rate and stock markets, and foreign exchange forward and money markets.

These developments have facilitated the growth of deeper and more efficient domestic markets, facilitating a more effective channel for transmission of monetary and financial policy impulses (Table 4.1).

India's experience once again demonstrates that the development of financial markets is an arduous and time-consuming task that requires conscious policy actions and effective implementation. Financial markets have to be created, nurtured and monitored on a continuous basis, as they attain maturation. The next four sections focus on the equity, government securities, foreign exchange and money markets, respectively. The strengths and weaknesses of each are identified keeping in view the growth of the market and the development of market infrastructure for each segment, and a way forward from the medium-term perspective is suggested. The regulatory and supervisory structure of these markets has been benchmarked against the IOSCO Principles for Securities Regulation which are taken to be international best practices (Box 4.1). Though the IOSCO principles are basically designed for the securities markets, keeping in mind the systemic

**Table 4.1 : Depth of Financial Markets in India – Average Daily Turnover**

(Rs. crore)

| Year | Money Market* | Government Securities Market+ | Foreign Exchange Market # | Equity Market (Cash Segment) ** | Equity Market (Derivative Segment - NSE)*** |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| 2000-01 | 42,657 | 2,383 | n.a. | 9,321 | 11 |
| 2001-02 | 65,500 | 6,557 | 24,891 | 3,322 | 413 |
| 2002-03 | 76,752 | 8,090 | 24,330 | 3,713 | 1,752 |
| 2003-04 | 28,660 | 7,572 | 36,097 | 6,310 | 8,388 |
| 2004-05 | 38,528 | 4,835 | 49,309 | 6,521 | 10,067 |
| 2005-06 | 60,034 | 3,673 | 56,391 | 9,504 | 19,220 |
| 2006-07 | 88,803 | 4,284 | 84,760 | 11,652 | 29,543 |
| 2007-08 | 1,38,640 | 6,990 | 1,35,794 | 20,438 | 52,153 |

* : Includes the call money, notice money, term money, CBLO and repo markets.
+ : Secondary Market Transactions as reported in Handbook of Statistics on the Indian Economy-Outright Transactions
# : Inter-bank turnover only.
** : Includes both BSE and NSE.
*** : Turnover/No of trading days
n.a. : not available
**Source:** RBI, SEBI

Financial markets have to be created, nurtured and monitored on a continuous basis, as they attain maturation.

**Box 4.1: IOSCO Principles for Securities Market Regulation**

In 2003 IOSCO endorsed a comprehensive methodology that enabled an objective assessment of the implementation of the IOSCO Principles in the jurisdictions of its members and the development of action plans to correct identified gaps in implementation. There are in all 30 principles that need to be in place for a regulatory and supervisory system to be effective. The assessment builds on answers to a set of key questions based on which the adherence or compliance status is scaled principle-wise as fully implemented, broadly implemented, partly implemented, not implemented or not applicable.[72] The principles can be categorised into nine categories:

**I. Principles relating to issuers**

Principle 1: Responsibilities of regulator which need to be objectively defined and clearly stated.

Principle 2: Operational independence and accountability in exercise of functions and powers of regulator.

Principle 3: Power, resources and capacity to perform regulatory functions.

Principle 4: Regulatory processes of regulator which should be clearly defined.

Principle 5: Professional standards of staff of regulator including appropriate standards of confidentiality.

**II. Principles relating to self-regulation**

Principle 6: Appropriate use of SROs.

Principle 7: Regulatory oversight over SROs and standards adopted by SROs.

**III. Principles relating to enforcement**

Principle 8: Inspection, investigation and surveillance powers.

Principle 9: Enforcement powers.

Principle 10: Credible use of inspection, investigation, surveillance and enforcement powers, as well implementation of effective compliance programme.

[72] **Fully implemented:** A principle will be considered to be fully implemented whenever all assessment criteria are generally met, without any significant deficiencies.
**Broadly implemented**: A principle will be considered to be broadly implemented whenever a jurisdiction's inability to provide affirmative response to applicable key questions for a particular principle is limited to the question excepted under the principle's broadly implemented benchmark and in the judgement of assessors such exceptions do not substantially affect the overall adequacy of the regulation that the principle is intended to address.
**Partly implemented**: A principle will be considered to be partly implemented wherever the assessment criteria are generally met without any significant deficiencies.
**Not implemented:** A principle will be considered to be not implemented whenever major shortcomings are found in adhering to the assessment criteria as specified in the not implemented benchmark.
**Not applicable:** A principle will be considered to be not applicable whenever it does not apply, given the nature of the securities market in the given jurisdiction and relevant structural, legal and institutional considerations.

**IV. Principles relating to co-operation**

Principle 11: Authority to share public and non-public information with domestic and foreign counterparts.

Principle 12: Information-sharing mechanisms with domestic and foreign counterparts.

Principle 13: Assistance provided to foreign regulators.

**V. Principles relating to issuers**

Principle 14: Full, timely and accurate disclosure of financial results.

Principle 15: Treatment of holders of securities in fair and equitable manner.

Principle 16: Accounting and auditing standards.

**VI. Principles relating to collective investment schemes (CIS)**

Principle 17: Standards for eligibility and regulation to market or operate CIS.

Principle 18: Rules governing legal form and structure of CIS.

Principle 19: Disclosure requirements of CIS.

Principle 20: Asset valuation and pricing and redemption of units in CIS.

**VII. Principles relating to market intermediaries**

Principle 21: Minimum entry standards.

Principle 22: Initial and ongoing capital and other prudential requirements.

Principle 23: Standards for internal organisation and operational conduct.

Principle 24: Procedure for dealing with failure of a market intermediary.

**VIII. Principles relating to secondary markets**

Principle 25: Establishment of trading systems, including securities exchanges.

Principle 26: Regulation and supervision of exchanges and trading systems.

Principle 27: Promotion of transparency in trading.

Principle 28: Detection and deterring manipulation and other unfair trading practices.

Principle 29: Proper management of large exposures, default risk and market disruption.

**IX. Principle relating to clearing and settlement of securities**

Principle 30: Clearance and settlement of securities transactions, which should be subject to regulatory oversight, and ensuring that they are fair, effective and efficient and also that they reduce systemic risk.

**Source:** International Organisation of Securities Commission (IOSCO)-May 2003.

importance of the other markets, *viz.*, the money and foreign exchange markets, these principles, as relevant and applicable, were also assessed for them.

A detailed assessment of the regulation and supervision of markets was undertaken by the Advisory Panel on Financial Regulation and Supervision. The draft report of the Advisory Panel was peer reviewed by Mr. Shane Tregillis, Deputy Managing Director, Market Conduct Group, Monetary Authority of Singapore and Mr. Ranjit Ajit Singh, Managing Director, Securities Commission, Malaysia. The peer reviewers had only commented on the assessment of IOSCO principles in respect of equity markets. The Advisory Panel Report on Financial Regulation and Supervision took on board the feedback of these two peer reviewers, and nuanced their assessment as appropriate.

The last two sections of this chapter address issues relating to developments of other important market segments, which are at an

embryonic state of development. These are the corporate bonds and credit derivatives markets.

## 4.2 Equity Market

The Indian equity markets have witnessed widespread changes over the past two decades. The establishment of the Securities and Exchange Board of India (SEBI) in 1988; the setting up of the National Stock Exchange (NSE) as the first de-mutualised stock exchange of the country in 1993; the introduction of Currency Future/Derivatives in NSE, BSE and MCX SE in 2008; demutualisation and corporatisation of the Stock Exchange, Mumbai (BSE)[73]; and improvements in corporate governance practices are some important initiatives that have led to a significant rise in the volume of transactions and the emergence of new and innovative instruments. In addition to the two national stock exchanges, *viz.*, the NSE and BSE, there are 17 regional stock exchanges. The importance of regional stock exchanges, however, has been on the decline in recent times.

*Infrastructure*

Market infrastructure has strengthened markedly. The equity markets have moved to T+1 and T+2 rolling settlement cycles in recent years, which significantly speeded up the transfer of cash and securities to the relevant counterparties, thereby reducing settlement risks. The seamless move towards shorter settlement periods has been enabled by a number of innovations. The introduction of electronic transfer of securities has brought down settlement costs markedly and ushered in greater transparency, while 'dematerialisation' has instituted a paper-free securities market.

Equity market infrastructure has strengthened markedly

Of the 19 Recognised Stock Exchanges (RSE) in India, equity trading is most active in the NSE and the BSE. Trading infrastructure in the stock exchanges is anonymous and order-driven, with all orders from market participants being matched based on strike price/time priority. Two depositories, *viz.*, National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Ltd. (CDSL) were established in 1996 and 1999, respectively, to enable paper-less trading.

The powers and functions of SEBI as the securities market regulator have been laid down in the SEBI Act, 1992. SEBI also exercises powers under

[73] Currently all stock exchanges other than Coimbatore Stock Exchange are corporatised and demutualised.

the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996 and certain provisions of the Companies Act, 1956. It regulates the securities markets, securities market institutions and market intermediaries, such as the stock exchanges, depositories, mutual funds and other asset management companies, securities dealers and brokers, merchant bankers, credit rating agencies and venture capital funds.

To sustain confidence in clearing and settlement of securities, NSE set up the National Securities Clearing Corporation Ltd. (NSCCL) in August, 1995 which carries out the clearing and settlement of the trades executed in the Equities and Derivatives segments and operates the Subsidiary General Ledger (SGL) for settlement of trades in government securities. Similarly, the BSE has its own clearing house.

Despite some bouts of volatility at different points in time, the market has not shown signs of instability.

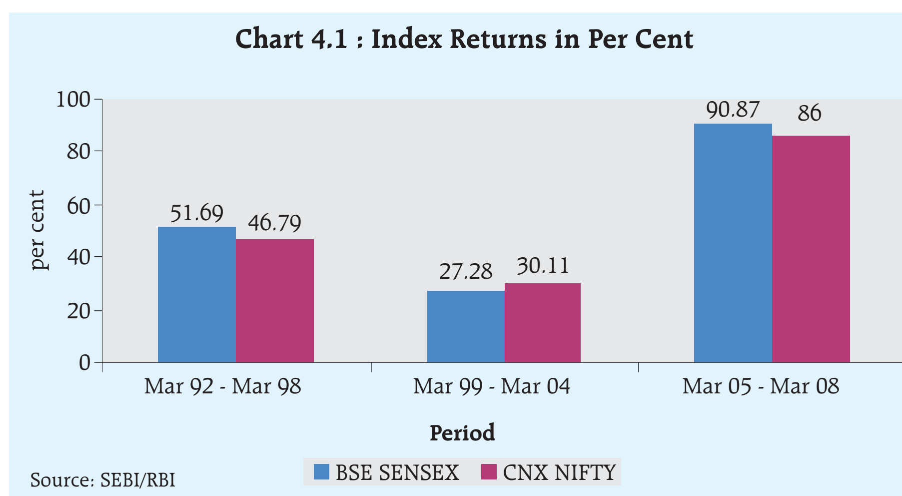
The stock exchanges have become better at risk management. Despite some bouts of volatility at different points in time, the market has not shown signs of instability. The circuit breaker system has been used effectively in negotiating with stock market volatility. Currently, the core of the risk management system is the liquid assets deposited by members with the exchange/clearing corporation which covers the four requirements, *viz.*, MTM (mark-to-market) losses, VaR Margins, Extreme Loss Margins and Base Minimum Capital. A Trade Settlement Guarantee Fund has been set up to ensure smooth settlement of transactions. Investors' or Customer Protection Funds are maintained by stock exchanges to compensate investors in the case of default by a member of the exchange. In addition, an Integrated Market Surveillance System (IMSS) was put in place by SEBI across the exchanges (NSE and BSE) and depositors (NSDL & CDSL) to monitor exposure across market segments (cash and derivatives) with effect from December, 2006. Also, NSE and BSE have in place their own surveillance systems to generate appropriate alerts and prevent market manipulation.

*Growth and Composition*

As at end-September 2008, 4,926 companies were listed on the BSE, which is the largest exchange in the country. The number of listed companies in NSE was 1,424, which are not exclusive of BSE. The buoyant secondary market has, *inter alia,* contributed to increased stock market returns as observed from the key indices of BSE and NSE, particularly in recent years (Chart 4.1). Since early 2008, however, there has been a downturn in the returns. Between the end of March 2008 and February 27, 2009 the daily index both at BSE and NSE (Sensex and Nifty) has shown a decline of around 43 per cent.

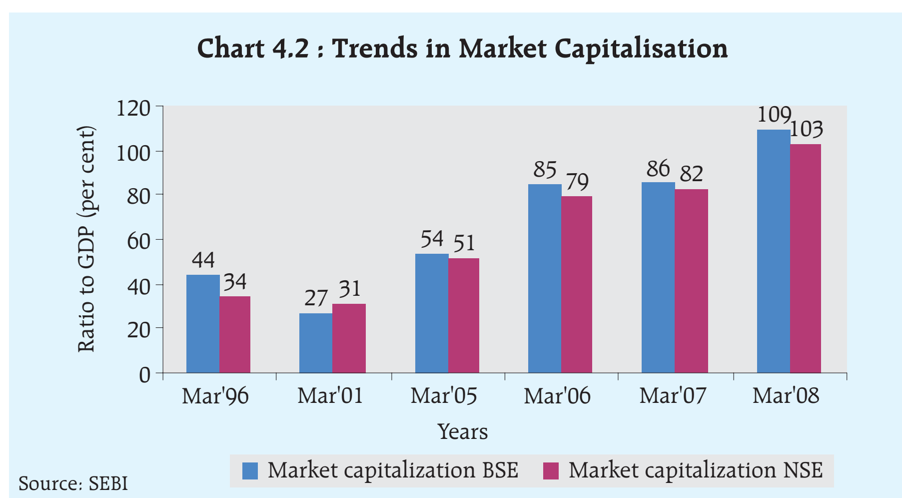
NSE and BSE have in place their own surveillance systems to generate appropriate alerts

The size of the market as measured by market capitalisation has increased sharply, signifying both a steep rise in stock prices and the listing of new companies until end 2007 (Chart 4.2). But since 2008, there has been considerable volatility, with a downward bias in market capitalisation and price-to-earnings ratios, largely due to global financial developments. The




recent volatility has not affected the smooth functioning of the stock markets and the settlement of trades. On the contrary, it has brought to the fore the resilience of the market infrastructure and its arrangements for risk management. This is also a pointer to the robust regulatory environment within which the equity market operates in India.

With the introduction of free pricing and enhancement in disclosure standards, Initial Public Offers (IPOs) have gained in popularity. Between 2003-04 and 2007-08, 267 IPOs amounting to Rs.86,471 crore were floated. In 2007-08, 82 IPOs amounting to Rs.39,894 crore entered the market. Simultaneously, the secondary market in equities – both in cash and derivatives trades – has become more active as evident from a sharp rise in the



value traded ratio (turnover to GDP). The average daily turnover of the cash segment in BSE and NSE were Rs.5,524 crore and Rs.12,919 crore in BSE and NSE, respectively, during April to August 2008. The average daily turnover of the derivative segment in BSE and NSE were Rs.4,608 crore and Rs.45,827 crore, respectively, during the same period.

The reduction in transactions costs and the development of the derivatives market by the introduction of index futures and options as also stock futures and options have helped to increase liquidity, leading to more effective price discovery. The NSE impact cost, which quantifies the impact of change in stock prices, has generally been showing a declining trend.

The Panel on Financial Stability Assessment and Stress Testing has, however, identified a few areas in the equity market which require focused attention. These are discussed in detail in the section on issues and concerns.

#### 4.2.1 Assessment of IOSCO Principles

The status of compliance to IOSCO principles in respect of the equity/ corporate bond market as assessed by the Advisory Panel on Financial Regulation and Supervision is summarised below:

Overall, the assessment shows that the number of principles fully implemented is 20, broadly implemented are 8 and partially implemented are 2. All the principles relating to secondary market trading, clearing and settlement have been fully implemented (Table 4.2).

The responsibilities of SEBI are well-defined. It regulates market players through a combination of on-site inspection, off-site reporting, investigation and surveillance of the market and regulated entities; there is full, timely and accurate disclosure of financial results and information that are material to investors' decisions; the holders of securities are treated in a fair and equitable manner; capital requirements have been prescribed for market intermediaries; and there is ongoing supervision of exchanges and trading systems to ensure the integrity of trading. The principles relating to responsibilities and operational independence and accountability of regulator; use of inspection, investigation, surveillance and enforcement powers; assistance provided to foreign regulators; accounting and auditing standards; standards for eligibility and regulation; minimum entry standards, capital and prudential requirements and procedure for dealing with failure of market intermediary are not fully implemented.

Based on the peer reviewer's observations, the Advisory Panel reviewed the assessment in respect of four principles, *viz.*, responsibilities of the regulator, operational independence and accountability, inspection and surveillance powers and standards for eligibility and regulation, and revised them from 'fully implemented' to 'broadly implemented'.

Reduction in transactions costs and development of the derivatives market have helped to increase liquidity.

The peer reviewers, while assessing issues relating to operational independence, suggested that the assessment should cover whether there is retention of certain powers by the Central Government and whether there is

**Table 4.2: Summary Assessment of Equity and Corporate Bond Market**

| Principle | Compliance status | | |
|---|---|---|---|
| 1 | 2 | 3 | 4 |
| **Principles of regulator** | | | |
| 1. Responsibilities of regulator | | BI | |
| 2. Operational independence and accountability | | BI | |
| 3. Power, resources and capacity to perform functions | FI | | |
| 4. Regulatory processes of regulator | FI | | |
| 5. Professional standards of staff of regulator | FI | | |
| **Principles relating to self regulation** | | | |
| 6. Regulatory regime | FI | | |
| 7. Regulators' oversight over SROs and standards adopted by SROs | FI | | |
| **Principles relating to enforcement** | | | |
| 8. Inspection, investigation and surveillance powers | FI | | |
| 9. Enforcement powers | FI | | |
| 10. Use of inspection, investigation, surveillance and enforcement powers | | BI | |
| **Principles relating to co-operation** | | | |
| 11. Authority to share information with domestic and foreign counterparts | FI | | |
| 12. Information-sharing mechanisms | FI | | |
| 13. Assistance provided to foreign regulators | | | PI |
| **Principles relating to issuers** | | | |
| 14. Disclosure of financial results | FI | | |
| 15. Treatment of holders of securities | FI | | |
| 16. Accounting and auditing standards | | BI | |
| **Principles relating to collective investment scheme** | | | |
| 17. Standards for eligibility and regulation | | BI | |
| 18. Rules governing legal form and structure | FI | | |
| 19. Disclosure requirements | FI | | |
| 20. Asset valuation and pricing and redemption of units | FI | | |
| **Principles relating to market intermediaries** | | | |
| 21. Minimum entry standards | | BI | |
| 22. Capital and prudential requirements | | BI | |
| 23. Internal organisation and operational conduct | | | PI |
| 24. Procedure for dealing with failure of market intermediary | | BI | |
| **Principles relating to secondary markets and clearing and settlement** | | | |
| 25. Trading systems | FI | | |
| 26. Regulatory supervision | FI | | |
| 27. Transparency of trading | FI | | |
| 28. Detection of manipulation and unfair trading practices | FI | | |
| 29. Management of large exposures, default risk and market disruption | FI | | |
| 30. Systems for clearing and settlement of securities | FI | | |
| **Total** | **20** | **8** | **2** |

FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable

**Source:** Advisory Panel on Financial Regulation and Supervision.

discretionary appointment and termination of SEBI's Chairman/members of the Board. The assessment also needs to elaborate on the training programmes, industry secondments and other measures that would help address the issue of skilled resources. The aspect on regulatory process needs to elaborate on the specific consultation mechanism in place, and whether there is a formal exposure mechanism for policy and rulemaking efforts. The assessment on professional standards needs to elaborate on whether there are any general conflict rules relating to investigation or submission for licensing application by parties, such as family members. As regards SROs, the role and functions played by some of the industry associations need to be examined in detail, whether any of these entities exercise quasi-SRO type responsibilities and, if so, whether sufficient oversight is being conducted by the regulator over these entities. These aspects were examined by the Panel and appropriately incorporated.

Checks and balances and accountability arrangements have to be a part of a sustainable regulatory model.

With a view to achieve convergence to IOSCO principles in areas where some gaps have been observed, the Advisory Panel has made appropriate recommendations. The views of the Advisory Panel that could be considered by SEBI and the Government are summarised below:

*Overlap of Jurisdiction*

The Panel was of the view that there is an overlap of jurisdiction between SEBI and the Government, with the Government having powers to issue directions to SEBI even if it is not a question of policy. The Panel recommended that Section 16 of the SEBI Act could be suitably amended, empowering policy directions to be issued in public interest only. Also, under Section 5(2) of the SEBI Act, the Central Government has the right to terminate the services of the Chairman or Member at any time by giving a notice of three months. This appears to be an apparent conflict with the tenor of the other sections in the SEBI Act and could have implications for the independence of SEBI. The Panel felt that Section 5(2) can be removed from the SEBI Act. Further, under the Companies Act, the Ministry of Corporate Affairs also has the power to make rules and prescribe schedules in respect of prospectus, and financial statements in respect of listed companies. In view of the above, the Panel has recommended that all capital market-related matters in respect of listed companies may be exclusively handled by SEBI.

The CFSA differs and feels that checks and balances and accountability arrangements have to be part of a sustainable regulatory model, as the regulator, with whatever autonomy, cannot stand in a vacuum. It also needs to be noted that the Ministry of Finance has never exercised these powers *vis-à-vis* Statutory Regulatory Agencies (SRAs). While the Government does not involve itself in day-to-day affairs on matters relating to regulation of capital markets, the CFSA feels that oversight by the Government is essential since this could provide breadth and depth to the market.

Oversight by the Government is essential, since this could provide breadth and depth to the market.

In this context the Government has pointed out that the allocation of responsibilities between the Central Government and SRAs is in accordance with the basic principles of the Indian Constitution. In the Indian scheme,

SRAs report to Parliament and are accountable to Parliament through the Executive. Vide Sec 16 of the SEBI Act, the Central Government has powers to issue directions 'on questions of policy' and it needs to be given in writing. However, on whether a question is policy or not, the decision of the Government is final. This is *pari-materia* with similar powers of the Central Government vis-à-vis other SRAs.

*Specific Conflict Rule for Staff*

SEBI staff is required to maintain secrecy and not make use of any information which comes to their knowledge in the discharge of their official duties. Also, they cannot communicate any such information to other persons except in the course of their official duty. However, there is no specific conflict rule in this regard. The Panel has recommended that there should be a specific conflict rule for the staff relating to investigations or consideration of licensing applications of related entities of staff.

*Comprehensive Inspection Programme for Intermediaries*

The Panel recommended a mechanism for supervision/monitoring of out-sourced inspection and also for supervision and monitoring of out-sourced activities of intermediaries. It also recommended that a comprehensive inspection policy/programme for all intermediaries could be adopted to increase overall effectiveness of enforcement.

*Private Right of Action*

It was observed that there was no specific provision empowering a private person to seek his or her own remedies for any misconduct relating to the securities law. Only SEBI is empowered to take action for any violation under the SEBI Act and regulations. The private right of action and/or a class action suit by investors could be allowed by law. The CFSA feels that as the purpose is to enhance accessibility of investors, it would be better if SAT/FSAT is further strengthened with regional branches.

*Disclosure and Investor Protection*

There are guidelines in this regard issued by SEBI. To impart enforceability, the existing guidelines on disclosure and investment protection may be converted into regulations.

*Related Party Transactions*

While all related party transactions have to be informed in the Annual Report and Audit Committee as per the Listing Agreement, it could be subject to shareholders' approval.

*Disclosure of Voting Patterns*

In the interests of transparency, it is desirable that the voting pattern on important decisions of significant shareholders is made public in relation to the capital market. This would be consistent with the Organisation of Economic Co-operation and Development (OECD) principles of corporate governance which include, *inter-alia*, the right to information.

*Regulation of Distributors*

The key channel in bringing mutual funds to a large number of investors all over the country is the network of distributors who have also taken on the role of financial advisors to investors. While SEBI has made it mandatory for any entity/person engaged in the marketing and selling of mutual fund products to pass the Association of Mutual Fund in India (AMFI) certification test (Advisor's Module) and to obtain a registration number from AMFI, it could consider regulation and licensing of such operators and distributors of mutual funds and distributors of securities in primary market.

*Market Intermediaries*

While SEBI has prescribed minimum capital adequacy requirements for market intermediaries operating within its regulatory domain, this was not based on the riskiness of assets. There could be a risk-based prudential capital requirement for these intermediaries along the lines of the capital adequacy requirement prescribed for primary dealers in the government securities market. It also recommends adequate internal control requirements for market intermediaries. Further, policy and procedures could be laid down for dealing with failure resolution of these entities.

Risk based capital requirement could be prescribed for market intermediaries.

*Secondary Markets*

Corporatisation and demutualisation of stock exchanges have brought new conflicts to the fore. While this has advantages like improved corporate governance and the opening up of trading rights, there need to be strong oversight requirements for demutualised exchanges. This is because demutualised exchanges need to balance their commercial objectives with those of protecting public interest, as the establishment of a private for-profit exchange could change its incentive structure and operating environment. The peer reviewer, Mr. Sundararajan, has recommended further consolidation of the numerous demutualised stock exchanges and competition from alternative trading systems as areas for development of the equity market. The Advisory Panel on Financial Stability Assessment and Stress Testing was, however, of the view that in the case of small demutualised stock exchanges (other than NSE and BSE), consolidation would be dependent on emerging market forces.

*Enhancement of Regulatory Coverage*

With the development of the retail segment, particularly in the equity market, there has been a proliferation of investment advisors and some of

Research analysts should be appropriately regulated.

them also manage portfolios of securities. There are also research analysts who are employed by investment and broking firms, underwriters or mutual funds. Such analysts often face conflicts of interest that can interfere with the objectivity of their analysis and hence could be brought within the regulatory ambit of SEBI. The CFSA notes that draft regulations in this regard have been put up on the SEBI website for public comments.

*Development of Trade/Industry Associations as Self- Regulatory Organisations (SROs)*

Trade and industry associations could be considered to perform as SROs with appropriate safeguards.

While SEBI is empowered to promote and regulate SROs, currently there are no recognised SROs under SRO Regulation. There are, however, certain organisations that currently function primarily as trade and industry associations, but perform some SRO-like roles. Such trade or industry associations could be considered for being accorded SRO status with appropriate safeguards, taking into account aspects relating to conflict of interest.[74] The CFSA notes that the SEBI is in process of modifying SRO regulations in consultation with international agencies.

**4.2.2 Issues and Concerns**

**4.2.21 Public Issues**

The private placement segment has increased sharply, but it lacks transparency.

The size of the public issue segment of the capital market has remained small though the average size of public issues has increased from Rs.296 crore in 2001-02 to Rs.703 crore in 2007-08, reflecting its subdued role in capital formation. Although the private placement segment of the market has increased sharply (due to an increase in the corporate debt segment), it lacks transparency and a large number of investors are left out of the market. The Panel on Financial Stability Assessment and Stress Testing has observed that with the Indian economy growing at a fast pace, the risk capital needed can only be provided by the capital market.

The book building process is the preferred mode of IPO issuance. As per extant norms, the payment upfront by 'qualified institutional buyers' (QIBs) is required to be at least 10 per cent of the total commitment[75]. This could lead to hype about over-subscription upfront particularly during a bull run, which

[74] More details in section 5.2.3 on Self-Regulatory Organisations.

[75] As per the Disclosure and Investment Protection Guidelines, the broker may collect an amount to the extent of 100 per cent of the application money as margin money from clients and investors, before he places an order on his behalf. An amount not less than 10 per cent of the application money is to be collected from Qualified Institutional Buyers (QIBs) in respect of bids placed by them as margin money.

has a malign impact on retail investors. Under the circumstances, the Panel on Financial Stability Assessment and Stress Testing felt that there is a case for getting institutional bidders to pay upfront the total amounts bid and not just a small percentage thereof.

**4.2.22 Equity Valuation**

The Price-Earnings (P/E) ratio rose from 20.7 (Sensex)[76] on January 1, 2004 to 28.0 (Sensex) as on December 11, 2007. The average PE ratio, which was 22.65 during 2007-08, was still higher than that in most of the developing markets (barring China) such as Indonesia (18.9), Turkey (17.6) and South Korea (15.3). The Panel on Financial Stability Assessment and Stress Testing considered that the current valuations appear over-stretched and had expressed concern about the sustainability of this high P/E ratio. The CFSA notes that due to the reversal in trend in stock markets during the current year, the current P/E ratio came down to 17.0 per cent by September 23, 2008 and further to 12.0 by October 31, 2008. The CFSA also notes that it would be a difficult proposition to take a view on stock market pricing based on the P/E ratio alone.

**4.2.23 Volatility**

Though volatility is an essential feature of the equity market, the Panel on Financial Stability Assessment and Stress Testing recognised that increased volatility would have an adverse impact on sentiments and could impact corporates' capacity to raise resources.

Beginning in 2003, the integration of Indian stock markets with global markets has strengthened. It has also shown high co-relation with Asian stock markets, barring China and Korea. The global integration of Indian stock markets is one of the reasons for its increased volatility from August 2007. The recent market volatility is due fears of the US economy heading towards a recession, a situation further aggravated by the sub-prime crisis. The CNX NIFTY saw an increase in annual volatility from 1.6 per cent in 2006 to 2.5 per cent in 2008[77].

Implied volatility, one of the important determinants of option pricing, had been low for most parts of the past four years, reflecting a bullish sentiment. The recent stock market declines have also not resulted, however, in an increase in implied volatility for both put and call options[78] in current financial year till August 2008.

It is difficult to take a view of stock market pricing based on the P/E ratio alone.

The derivatives markets have witnessed a sharp increase in open interest in stock futures. A very high open interest could be potentially destabilising and could instill volatility in the spot markets. This has been

[76] Source: Bloomberg.
[77] From January 1, 2008 to July 31, 2008.
[78] Panel Report on Financial Stability Assessment and Stress Testing.

Recent volatility has brought to the fore the resilience of equity market.

evident in recent times when the open interest has come down drastically due to the sharp correction in domestic stock markets[79].

The CFSA notes that the recent volatility in the stock markets has brought to the fore the resilience of the market. In spite of stock markets witnessing a rapid fall in market capitalisation there has been no breakdown in the settlement systems. This is a pointer to the robust regulatory environment within which the equity market operates in India.

**4.2.24 Risk Management**

Many equity houses fix their daily VaR levels as a measure of risk management. The Panel on Financial Stability Assessment and Stress Testing felt that given the volatility (as witnessed in recent times) there was a need for stress testing of VaR limits to consider any adjustments. The confidence level used for computing VaR may also need some revisions. Further, many of the equity houses set their 'stop loss' triggers by aligning them with these 'VaR' levels. This practice may exacerbate the decline in equity prices, as a breach in value below this level may result in large-scale selling, further depressing the values. Simulation models need to be developed to assess the impact of such market practices, and mitigation measures could be adopted at the stock exchange level. The CFSA feels that the suggestion of the Panel should be considered by the Government/SEBI.

**4.2.25 Further Measures**

The Advisory Panel on Financial Stability Assessment and Stress Testing suggested a few more measures for further development of the equity market. These are:

- Setting up a Central Integrated Platform (CIP) connecting multiple nodes, including the internet and broker terminals, for enabling investors to apply electronically in public issues.
- Simplification of the debt issuance process with a view to rationalising public issues.
- Enhancement of knowledge standards of the current and potential market participants through national investor education and financial literacy.
- Strengthening inter-exchange cross-market surveillance to consider serious contagious risks.

There is a need for stress testing of VaR limits.

[79] Panel Report on Financial Stability Assessment and Stress Testing.

The Panel on Institutions and Market Structure has recommended faster convergence of Indian Accounting Standards (IAS) with International Financial Reporting Standards (IFRS). The Panel on Financial Regulation and Supervision recognised this as a key element for the development of equity markets.

Convergence of IAS with IFRS is a key element for the development of equity market.

The CFSA is of the view that the equity markets have witnessed major improvements over the years in market infrastructure and risk management systems. While market volatility continues to exist, it may be borne in mind that in recent years, in spite of the volatility in the markets, the systems continue to be robust. However, in the interests of ongoing market development, the above observations of the Advisory Panels may be duly considered by the government, SEBI and ICAI.

**4.2.3 Summary**

The Indian equity markets have witnessed widespread changes over the past two decades. Some important initiatives that have been taken in recent times are the establishment of the Securities and Exchange Board of India (SEBI) in 1988; the setting up of the first demutualised exchange of the country, *viz.*, the National Stock Exchange (NSE) in 1993; the introduction of a variety of derivative products on Indian exchanges; demutualisation and corporatisation of the Stock Exchange, Mumbai (BSE); and improvement in corporate governance practices.

There has been a significant improvement in market and settlement infrastructure. Stock exchanges have also taken major strides in risk management and, despite some bouts of volatility at different points in time, the market has not shown signs of instability. Turnovers in both the cash and derivatives markets have gone up and market capitalisation and returns from stock markets increased considerably till end-2008. The current year, however, has seen considerable volatility with a downward bias in recent times, largely due to global developments.

The assessment of IOSCO principles in respect of equity and corporate bond markets has revealed compliance to most of the principles. There are, however, some gaps in areas of responsibilities of the regulator; operational independence and accountability; inspection, investigation and surveillance powers; assistance provided to foreign regulators; minimum entry standards, capital and prudential requirements; internal organisation and operational conduct of market intermediaries; and procedure for dealing with the failure of a market intermediary. The key observations of the Panel are listed below:

- While the overlaps between the role of the Reserve Bank and SEBI have been significantly reduced with clear demarcation of responsibilities, significant overlap still remains between the Government and SEBI, with the Government having powers to issue directions to SEBI even if it is not a question of policy. The CFSA notes that the Ministry of Finance has never exercised these powers *vis-à-vis* SRAs. While the

Government should not involve itself in day-to-day affairs on matters relating to regulation of capital markets, the CFSA feels that oversight by the Government is essential since this could provide breadth and depth to the market.

- There is a need for specific conflict of interest rules for the staff at SEBI relating to investigation or consideration of licensing applications of related entities of staff.
- A comprehensive inspection policy/programme for all intermediaries could be adopted to increase overall effectiveness of enforcement. To impart enforceability, the existing guidelines on disclosure and investor protection may be converted into regulations.
- While all related party transactions have to be informed in the Annual Report and Audit Committee as per the Listing Agreement, it could be subject to shareholders' approval.
- In the interests of transparency, it is desirable that the voting pattern on important decisions of significant shareholders be made public.
- Risk-based prudential capital requirements, internal control requirements and policy and procedures for dealing with failure resolution of market intermediaries are required.
- Research analysts who are employed by investment, broking, underwriter or mutual funds need to be brought within the regulatory ambit of SEBI.
- As regards certain organisations that currently function primarily as trade and industry associations, but perform some SRO-like roles, SEBI is in process of modifying regulation in consultation with international agencies so that they can be accorded SRO status with appropriate safeguards.

In the interests of developing the market further, there is a need for getting institutional bidders to pay upfront the total amounts bid and not just a small percentage thereof; the current requirement of paying at least 10 per cent of the total amount bid by the QIBs creates hype about oversubscription upfront, particularly during a bull run, which has a malign impact on retail investors.

Given the volatility witnessed in recent times, there is a need for improving risk management by market participants. In this context there is a need for stress testing of VaR limits to consider any adjustments. Simulation

models need to be developed to assess the impact of such market practices, and mitigation measures could be adopted at the stock exchange level.

Other issues that merit consideration are setting up a Central Integrated Platform (CIP) with multiple nodes to enable investors to apply in public issues electronically, simplification of the debt issuance process with a view to rationalising public issues, strengthening inter-exchange cross-market surveillance to consider serious contagion risks and faster convergence of IAS with IFRS. Enhancement of knowledge standards for current and potential market participants is also a key issue.

## 4.3 Foreign Exchange Market

Over time, the foreign exchange market has acquired depth and has generally remained orderly. The spill-over effect of the East Asian crisis was kept at a minimum through appropriate monitoring and a series of regulatory measures to deter self-fulfilling speculative activities. However, the recent global financial turmoil has triggered an increased volatility in the foreign exchange market. The Indian economy is moving towards fuller capital account convertibility, albeit in a calibrated manner.

*Infrastructure*

The foreign exchange market in India comprises two segments, *viz.*, spot and derivatives markets. The foreign exchange derivatives instruments in India are foreign exchange forwards, foreign currency rupee and cross-currency swaps and options. Exchange-traded currency futures have recently been introduced in India. The players in the Indian market include authorised dealers (ADs), foreign exchange brokers and individuals/corporates.

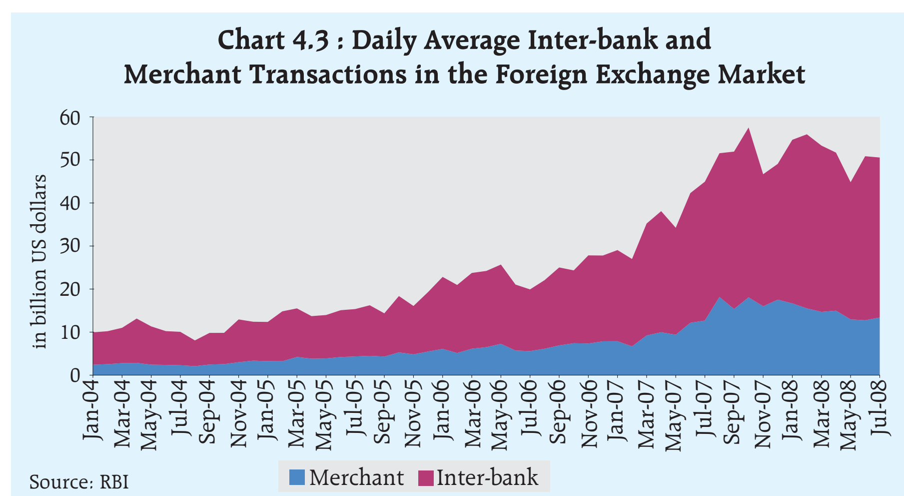
The Reserve Bank regulates the foreign exchange markets. The Foreign Exchange Dealer's Association of India (FEDAI) frames rules governing the conduct of inter-bank foreign exchange business among banks *vis-à-vis* the public and liaises with the Reserve Bank for reforms and the development of the foreign exchange market. There is no legal framework stipulating mandatory Reserve Bank oversight of FEDAI. Settlement of operations relating to foreign exchange markets is generally done by CCIL. There are various trading platforms for the conduct of spot and forward trading. The market infrastructure for spot, outright forward and swap deals in foreign exchange between authorised dealers involves facilities for direct bilateral screen-based trading and brokered trading. Detailed guidelines by the Reserve Bank are in place for banks to manage foreign exchange risks efficiently.

The foreign exchange market has acquired depth and has generally remained orderly

*Growth and composition*

The Indian foreign exchange market has grown exponentially over the past several years. The daily average turnover has seen a substantial pick up, from about US $ 5 billion during 1997-98 to US $ 49 billion during 2007-08 (Chart 4.3). The inter-bank to merchant turnover ratio has more than halved

**Chart 4.3 : Daily Average Inter-bank and Merchant Transactions in the Foreign Exchange Market**




Source: RBI

from 5.2:1 during 1997-98 to 2.5:1 during 2007-08, reflecting the growing participation in the merchant segment of the foreign exchange market.

Turnover in the foreign exchange market has increased steeply, the Compounded Annual Growth Rate (CAGR) between 1997-98 and 2007-08 being around 25 per cent. The growth has been particularly impressive in the past three years, beginning 2005-06, when it grew at 52 per cent, 49 per cent and 87 per cent, respectively.

The triennial survey of BIS 2007 observes a significant increase in India's share of aggregate turnover at current exchange rates and places India's foreign exchange market as one of the fastest growing across countries (Table 4.3). The CFSA is of the view that the expansion in turnover is likely to be related to strong economic growth and the increasing depth and openness of domestic financial markets in the economy.

The spot market remains the most important segment, accounting for 50 per cent of the total turnover. In the derivatives market, foreign exchange swaps account for the largest share of the total derivatives turnover, followed by forwards. Options have remained insignificant despite being in existence for more than three years (Table 4.4). With restrictions on direct participation in foreign exchange swaps and options by corporates in India, the turnover in these segments essentially reflects inter-bank transactions.

The spot market remains the most important segment followed by swap market.

Before the current global financial crisis, there was a perceptible increase in liquidity in the foreign exchange market as seen from the low and stable bid-ask spreads and the increased turnover in this segment. Between 2003 and 2008, the bid-ask spread remained range bound, around two basis

**Table 4.3: Geographical Distribution of Reported Foreign Exchange Market Turnover**

| | Daily averages in April in per cent | | | |
|---|---|---|---|---|
| | 1998 | 2001 | 2004 | 2007 |
| 1 | 2 | 3 | 4 | 5 |
| Australia | 2.4 | 3.2 | 4.2 | 4.3 |
| France | 3.7 | 3.0 | 2.6 | 3 |
| Hongkong SAR | 4.0 | 4.1 | 4.2 | 4.4 |
| **India** | **0.1** | **0.2** | **0.3** | **0.9** |
| Japan | 6.9 | 9.1 | 8.2 | 6.0 |
| Korea | 0.2 | 0.6 | 0.8 | 0.8 |
| New Zealand | 0.4 | 0.2 | 0.3 | 0.3 |
| Singapore | 7.1 | 6.2 | 5.2 | 5.8 |
| Sweden | 0.8 | 1.5 | 1.3 | 1.1 |
| Switzerland | 4.2 | 4.4 | 3.3 | 6.1 |
| UK | 32.5 | 31.2 | 31.0 | 34.1 |
| US | 17.9 | 15.7 | 19.2 | 16.6 |

**Source:** BIS Triennial survey - 2007

points, with a few spurts, going up to four basis points. However, since September 2008, a considerable amount of volatility has been observed in the foreign exchange market, which has led to instances of high bid-ask spreads in this period.

As part of further developing the derivatives market in India and adding to the existing menu of foreign exchange hedging tools available to residents, currency futures have been introduced in recognised stock exchanges or new exchanges recognised by SEBI. The currency futures market would function subject to the directions, guidelines and instructions issued by the Reserve Bank and SEBI from time to time. With the introduction of Section 45 W of the RBI Act, 1934, while the Reserve Bank is empowered to determine the policy relating to interest rates or interest rate products and other derivatives and give directions on that behalf, the procedure for execution or settlement of the trades in respect of these transactions on the Stock Exchanges recognised under Section 4 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) shall be regulated by SEBI.

**Table 4.4: Indicators of Indian Foreign Exchange Market Activity**

| | **April 1997-March 1998** | **April 2005-March 2006** | **April 2006-March 2007** | **April 2007-March 2008** |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| Total annual turnover* | 1,306 | 4,404 | 6,571 | 12,305 |
| Inter-bank to Merchant ratio | 5.2:1 | 2.6:1 | 2.7:1 | 2.5:1 |
| Spot/Total Turnover (per cent) | 51.6 | 50.5 | 51.9 | 49.7 |
| Forward/Total Turnover (per cent) | 12.0 | 19.0 | 17.9 | 19.3 |
| Swap/Total Turnover (per cent) | 36.4 | 30.5 | 30.1 | 31.1 |

Amount in US $ billion
**Source:** RBI

The demand for non-deliverable forwards (NDFs) arises principally out of regulatory and liquidity issues of the underlying currencies. These derivatives allow overseas entities that do not have access to on-shore foreign exchange markets to hedge or take speculative positions in non-convertible local currencies. On-shore financial institutions are not allowed to transact in the NDF markets. While these are largely concentrated in Singapore, they are also traded in Hong Kong, London and New York.

Rupee NDFs are reported to have grown in volume and depth over the past decade. The BIS Quarterly review for 2004 puts the average daily cash NDF turnover of Indian rupees in Asian markets at around US $ 250 million. While no specific data is available in this respect, anecdotal evidence suggests that the daily turnover in this segment is currently around US $ 1 billion, which is small compared with the daily turnover in on-shore markets.

**4.3.1 Assessment of IOSCO Principles**

The status of compliance to IOSCO principles in respect of foreign exchange market as assessed by the Advisory Panel on Financial Regulation and Supervision on is summarised below.

While most of the applicable principles relating to the regulator, enforcement, market intermediaries, secondary markets and clearing and settlement systems are fully implemented, there are five principles that are partly implemented. The principles relating to operational independence and accountability, co-operation and detection of manipulation and unfair trading practices are not fully implemented. The principles relating to self-regulatory organisations, collective investment schemes, accurate disclosure of financial results, fair and equitable treatment of shareholders, and accounting and auditing standards are not applicable to the foreign exchange market (Table 4.5).

With a view to achieve convergence to IOSCO principles in those areas not implemented, the Advisory Panel on Financial Regulation and Supervision has made appropriate recommendations. The issues and concerns along with major recommendations emanating from the assessment of the Panel on Financial Stability Assessment and Stress Testing are provided in the next section.

Rupee NDFs are reported to have grown in volumes.

**4.3.2 Issues and Concerns**

**4.3.21 Price Discovery**

The Panel on Financial Stability Assessment and Stress Testing felt that putting in place a process of ongoing surveillance of FEDAI accredited brokers

**Table 4.5: Summary Assessment of Foreign Exchange Market**

| Principle | Status of Compliance | | | |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| **Principles of regulator** | | | | |
| 1. Responsibilities of regulator | FI | | | |
| 2. Operational independence and accountability | | | PI | |
| 3. Power, resources and capacity to perform functions | FI | | | |
| 4. Regulatory processes of regulator | FI | | | |
| 5. Professional standards of staff of regulator | FI | | | |
| **Principles relating to self regulation** | | | | |
| 6. Regulatory regime | | | | NA |
| 7. Regulators' oversight over SROs and standards adopted by SROs | | | | NA |
| **Principles relating to enforcement** | | | | |
| 8. Inspection, investigation and surveillance powers | FI | | | |
| 9. Enforcement powers | FI | | | |
| 10. Use of inspection, investigation, surveillance and enforcement powers | FI | | | |
| **Principles relating to co-operation** | | | | |
| 11. Authority to share information with domestic and foreign counterparts | | | PI | |
| 12. Information-sharing mechanisms | | | PI | |
| 13. Assistance provided to foreign regulators | | | PI | |
| **Principles relating to issuers** | | | | |
| 14. Disclosure of financial results | | | | NA |
| 15. Treatment of holders of securities | | | | NA |
| 16. Accounting and auditing standards | | | | NA |
| **Principles relating to collective investment scheme** | | | | |
| 17. Standards for eligibility and regulation | | | | NA |
| 18. Rules governing legal form and structure | | | | NA |
| 19. Disclosure requirements | | | | NA |
| 20. Asset valuation and pricing and redemption of units | | | | NA |
| **Principles relating to market intermediaries** | | | | |
| 21. Minimum entry standards | FI | | | |
| 22. Capital and prudential requirements | FI | | | |
| 23. Internal organisation and operational conduct | FI | | | |
| 24. Procedure for dealing with failure of market intermediary | FI | | | |
| **Principles relating to secondary markets and clearing and settlement** | | | | |
| 25. Trading systems | FI | | | |
| 26. Regulatory supervision | FI | | | |
| 27. Transparency of trading | FI | | | |
| 28. Detection of manipulation and unfair trading practices | | | PI | |
| 29. Management of large exposures, default risk and market disruption | FI | | | |
| 30. Systems for clearing and settlement of securities | FI | | | |
| **Total** | **16** | | **5** | **9** |

FI-Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable

**Source:** Advisory Panel on Financial Regulation and Supervision.

and monitoring with suitable disincentives for breach/violation of the code of conduct could be considered. In this context, the CFSA feels that the necessity for applying stringent norms in respect of foreign exchange brokers needs to be examined further as these brokers are not allowed to hold positions in foreign exchange and, therefore, may not impact market stability very significantly.

The Panel had also seconded the proposal made by the Committee on Fuller Capital Account Convertibility (CFCAC 2006) that an electronic trading platform for the conduct of all foreign exchange transactions (including derivatives) be introduced. A similar recommendation has also been made by the Panel on Financial Regulation and Supervision.

Electronic trading platforms function as broking systems and as such do not require any approval from the Reserve Bank under FEMA as authorised persons. They perform activities similar to voice brokers, but use different channels of communication and technology. Hence, there is an opinion that they should be subjected to the same regulatory discipline as brokers. Such trading platforms in India are not covered under the Payment and Settlement Systems Act, 2007. Only in the event of such trades getting translated into payment instructions resulting in clearing/ settlement and the same entity carrying out these functions would the provisions of the PSS Act get attracted. Currently, foreign exchange brokers in India are accredited by FEDAI and the system has been working well. Therefore, there is no need for amending FEMA and bringing these entities under the ambit of the Reserve Bank.

**4.3.22 Capital Adequacy Norms**

As regards capital adequacy norms for market intermediaries, the Panel on Financial Regulation and Supervision note that there are three types of intermediaries in the foreign exchange market, namely, Authorised Dealers (Category I) which are commercial banks; Authorised Dealers (Category II) which are co-operative banks, regional rural banks and full-fledged money changers; and Authorised Dealers (Category III) which are development financial institutions and non-banking financial companies. Initial capital and risk-based capital requirements are specified separately for banks, DFIs and NBFCs. There are no risk-based capital requirements for full-fledged money changers (FFMCs). There could be a need for considering some capital requirement for these entities. The CFSA concurs with the Panel's views.

The necessity for applying stringent norms in respect of foreign exchange brokers needs to be examined further.

#### 4.3.23 Accounting and Disclosure

Given the varied practices of accounting and reporting followed by corporates as regards derivatives, it is difficult to figure out the exact profit or loss made by them or the exact quantum of market and credit risks that these entities are exposed to. A need has been, therefore, expressed to have a uniform accounting regime across banks and corporates and place the responsibility for risk containment squarely on the management of entities holding such risks. Though ICAI has issued AS 31 (disclosures and presentation of financial instruments) and AS 30 (recognition and measurement of financial instruments), which will be adopted for voluntary implementation effective April 1, 2009, the Panel on Financial Stability Assessment and Stress Testing is of the view that disclosure of foreign exchange derivative transactions by non-bank entities needs to be introduced sooner to enable market participants to assess the risks assumed by the entities. The Panel on Financial Regulation and Supervision further recommends that it is desirable that banks enter into derivatives contracts with only those corporates that adopt the revised accounting standards. The CFSA is of the view that it may not be practical to advise banks not to deal with companies if they have not implemented AS 30. However, this condition could be stipulated in respect of complex and structured derivatives. As a first step, corporates should be incentivised to implement AS 30. Lack of appropriate standards could lead to institutions being unaware of the inherent risks in such derivatives exposure, which could result in over-leveraging. Therefore, there should be adequate monitoring and regulation.

Corporates should be incentivised to adopt a uniform accounting system.

At the same time, the CFSA notes that the current crisis has brought to the fore issues relating to fair value accounting. Though fair value accounting definitely introduces procyclicality, it cannot be wished away. Hence, doing away with fair value accounting and going back to historical accounting may not be the correct option. One way around the problem is to make capital adequacy and provisioning requirements take into account the cyclical effects of the economy. It would mean making higher provisions during good times and enhancing capital adequacy so that it would act as a cushion during bad times. This would also require an enhanced role for supervisors who need to look into the risk profile of individual banks and suggest increased provisioning or capital requirement. Another option would be to increase the frequency of disclosures along with fair value accounting, so that stakeholders are fully aware of the procyclical element in the balance sheet of the banks. Further, carrying out stress tests based on fair values of the balance sheet and disclosing these results would help.

Doing away with fair value accounting may not be the correct option.

#### 4.3.24 Settlement Risks

Guaranteed settlement of transactions by CCIL is not extended to forward trades which, if introduced, could reduce risks and consequently capital charge, resulting in improvement in systemic efficiency and reduction in defaults. The Panel on Financial Stability Assessment and Stress Testing feels that CCIL could consider extending guarantees to forward trade. The

CFSA concurs with the view of the panel and feels that the enactment of the Payment and Settlement Systems Act may enable resolution of some of the operational issues in this regard. The CFSA also suggests that all OTC trades be compulsorily recorded and settled through a clearing corporation.

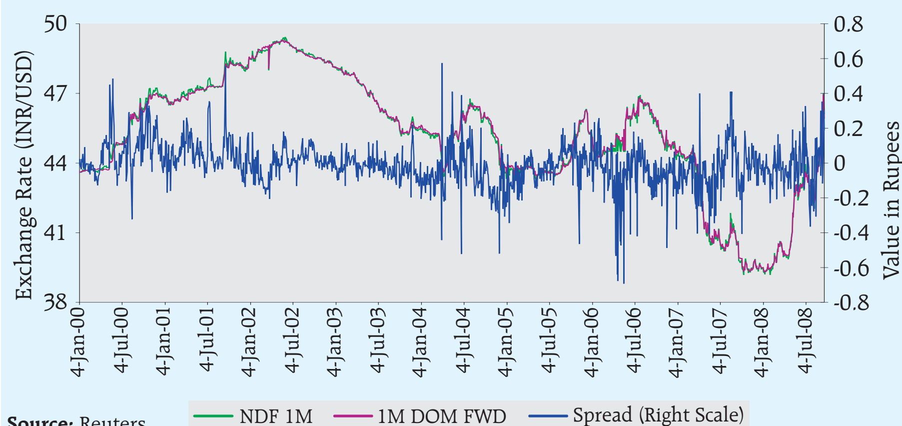
### 4.3.25 Trading in Off-shore Locations

The significant increase in the traded volumes in the foreign exchange markets has resulted in a substantial rise in foreign exchange derivatives products. In addition to INR/USD NDF contracts, currency and interest rate derivatives are being traded in off-shore locations (Chart 4.4). This demand is a consequence of expanded interest among global investors in the 'India' asset class. This market is not regulated and there is a paucity of information on participants trading in such products, which results in uncertainty. With the gradual advent of fuller capital account convertibility, the Panel on Financial Stability Assessment and Stress Testing is of the view that the Reserve Bank could consider allowing on-shore banks to trade in non-deliverable forwards (NDFs) directly with Authorised Dealers in India. In the opinion of the Panel, this would act as a means of reducing observed spikes in volatility from one 'close' to the next 'open' which could be attributed to the illiquidity and lack of depth of the NDF market that has an impact on the US$/Re well beyond the extent justifiable by its small size.

While appreciating the concerns raised by the Panel, the CFSA feels that allowing authorised dealers to participate in the NDF market would be tantamount to internationalising the rupee, which is not advisable at the current stage of capital account convertibility.

Allowing authorised dealers to participate in the NDF market would be tantamount to internationalising the rupee.

**Chart 4.4 : Comparison of 1 month forward in NDF & Domestic Markets**




**Source:** Reuters

#### 4.3.26 Carry Trade

In order to address the currency risk arising out of banks' outstanding carry trade positions, the Panel on Financial Stability Assessment and Stress Testing makes the following recommendations:

i) Banks should have, at the point of sale, a limit in place on losses on carry trades entered into by customers, which could be pre-agreed with the customers.

ii) The restructuring of open rupee derivative trades (restructuring is tantamount to cancellation and rebooking, which is not allowed currently) to embed risk mitigants like caps can be allowed.

iii) IAS 39 (through its local equivalent, AS 30) should be implemented, with a 2-year grace period to enable corporates to restructure their derivatives portfolios into clearly demarcated 'trading' and 'hedging' transactions.

The CFSA feels that the term 'carry trade' is generic in nature and it may be difficult to specify a transaction as a carry trade at the point of sale. In any case, corporates are allowed to trade in a derivative contract only to hedge an underlying exposure. However, in the interests of systemic risk containment, such a limit may be considered in respect of all complex derivative contracts entered into by a corporate with a bank. The Reserve Bank should examine this issue in detail.

A limit may be considered in respect of complex derivative contracts.

#### 4.3.27 Appropriateness and Capacity Building

The existence of significant diversity in the derivatives products brings up issues relating to product suitability and capacity building. Most banks do not have an adequate suitability and appropriateness policy despite guidelines being in place. The Panel on Financial Stability Assessment and Stress Testing has felt that high priority requires to be given to 'customer appropriateness' and 'suitability standards' as also capacity building among both market participants and regulators. The CFSA, while endorsing the view of the Panel, is also of the opinion that lack of such suitability and appropriateness standards often results in over-leveraging of such products by institutions, which could lead to losses and, therefore, needs to be monitored and, if necessary, even regulated.

#### 4.3.28 Aggregate Gap Limits

The Panel on Financial Stability Assessment and Stress Testing was of the view that there is a case for moving from the present system of monitoring of Aggregate Gap Limit (AGL)[80] to a PV01[81] monitor coupled with a

High priority needs to be given to 'suitability' and 'appropriateness standards'

[80] Aggregate Gap Limit is the sum total of gaps in each currency which should be arrived at by adding (not netting) the plus and minus position for each month. The aggregate gap limits should normally be related to owned funds of the bank in order to reflect the capacity of bank to absorb losses arising from the existence of gaps.

[81] PV01 is the present value impact of one basis point move in an interest rate. It is often used as a price alternative to duration (a time measure). It is also known as DV01 (Dollar Value of one basis point). Duration is useful primarily as a measure of the sensitivity of a bond's market price to interest rate (*i.e.*, yield) movements, it is approximately equal to the percentage change in price for a given change in yield.

Value at Risk (VaR) model, which captures the risk better and is more aligned to Basel II norms. This recommendation has been seconded by the peer reviewer, Mr Sundararajan, who however cautioned that it would also require supervisory validation of the models. The Panel recommended that the Reserve Bank should introduce a flexible system of reporting based on these criteria, with bank managements held accountable for implementing the principles thereof. As this process would require supervisory validation of VaR models, supervisory capacity building is important. The CFSA concurs with the Panel's recommendation.

**4.3.29 Expanding Options for Foreign Currency Hedging**

There has been a significant increase in the size of the foreign exchange market in terms of volume. The market has also matured in terms of the types and complexities of the instruments being used. Consequently, the foreign exchange exposure of the Indian corporate sector has increased manifold. Unhedged corporate exposure in foreign exchange entails a systemic risk and it is in the interests of the entire financial sector to add further options for hedging in respect of the foreign currency exposures of corporates. In this context the Panel for Financial Regulation and Supervision felt that, in the interests of systemic stability, all restrictions requiring underlying need to be abolished in a phased manner within a given timeframe. The CFSA recognises that the concept of economic exposure has been accepted by the Reserve Bank for permitting hedging. It believes that the Reserve Bank could undertake an in-depth examination of the pros and cons of this recommendation before doing away with the requirement of underlying altogether.

**4.3.30 Development of Trade Industry Associations as Self-Regulatory Organisations (SROs)**

It has been recommended that FEDAI should be made a full-fledged SRO by giving it more powers and that it be brought under the regulatory purview of the Reserve Bank[82]. The Foreign Exchange Dealers' Association of India (FEDAI) is an industry association which performs SRO like functions. It could be made a full-fledged SRO after assessing issues relating to governance, such as the composition of its board and the independence of directors, the independence and functioning of key committees of the board, and transparent disclosure practices so that any associated conflicts of interest are duly addressed.

FEDAI can be a full fledged SRO after assessing issues related to governance.

[82] The CFSA's views in this regard are given in detail in Chapter 5, Section 5.2.3 on self-regulatory organisations.

### 4.3.3 Summary

India's foreign exchange market is one of the fastest growing across countries – a likely consequence of strong economic growth and the increasing depth and openness of domestic financial markets in the economy. The growth is evidenced both in the spot and derivatives segments. Other than increased turnover, the liquidity of the market is evidenced from the bid-ask spread of the Re/US$ exchange rate which was low and stable until recent months. With a view to further developing the derivatives market in India and adding to the existing menu of foreign exchange hedging tools available to residents, currency futures have been introduced in recognised stock exchanges by SEBI. In addition to on-shore spot and derivatives markets, another segment that is fast picking up is the off-shore non-deliverable forwards (NDF) market; however, the market is small compared with the size of the on-shore market.

The assessment of the foreign exchange market to IOSCO principles reveals that there are gaps in areas relating to operational independence and accountability, co-operation and detection of manipulation and unfair trading practices.

Currently, electronic trading platforms function as broking systems and as such do not require any approval from the Reserve Bank under FEMA as authorised persons. They perform activities similar to voice brokers, but use different channels of communication and technology. Hence, they should be subjected to the same regulatory discipline as brokers. Such trading platforms in India are not covered under the Payment and Settlement Systems Act, 2007. Only in the event of such trades getting translated into payment instructions resulting in clearing/ settlement and the same entity carrying out these functions would the provisions of the PSS Act get attracted. Currently, foreign exchange brokers in India are accredited by FEDAI and the system has been working well. Therefore, there is no need for amending FEMA and bringing these entities under the ambit of the Reserve Bank.

There is need for a uniform accounting regime across banks and corporates. In respect of complex and structured derivatives products, it is desirable that banks enter into derivatives contracts with only those corporates that adopt the revised accounting standards, *i.e.*, AS 30 and AS 31. This along with disclosure of foreign exchange derivative transactions by non-bank entities needs to be considered to enable market participants to assess the risks assumed by the entities.

Guaranteed settlement of transactions by CCIL is not extended to forward trades, which if introduced could reduce risks resulting in improvement in systemic efficiency and reduction in defaults. The recording and settlement of all OTC trades should be made compulsory through a clearing corporation.

Allowing on-shore banks to trade in non-deliverable forwards (NDFs), as recommended by the Panel, directly with Authorised Dealers in India may not be feasible at the current stage of capital account convertibility.

While it is difficult to specify any transaction as carry trade, the feasibility of having a limit in place on losses arising out of exposure to complex derivatives may require to be examined in detail. The extent of leveraging by institutions needs to be monitored and, if necessary, regulated. Also, high priority requires to be given to 'customer appropriateness' and 'suitability standards' as also capacity building among both market participants and regulators. Further, there is a case for moving from the present system of monitoring of AGL to a PV01 monitor coupled with a Value at Risk (VaR) model. This would capture the risk better, and be more aligned with Basel II norms.

The Foreign Exchange Dealers' Association of India (FEDAI) is and industry association which performs SRO like functions. It could be made a full-fledged SRO after assessing issues relating to governance, such as the composition of its board and the independence of directors, the independence and functioning of key committees of the board, and transparent disclosure practices so that any associated conflicts of interest are duly addressed.

## 4.4 Government Securities Market

The development of the government securities market has been pursued since the early 1990s with the objectives of ensuring smooth conduct of the government's market borrowings, enlarging the investor base and facilitating the emergence of a risk-free rupee yield curve. Some significant reform measures include the introduction of an auction system for issuance of government securities, the introduction of a screen-based order matching system for secondary market trades, fostering market intermediaries in the form of primary dealers, encouraging retail participation in the primary market (through a system of non-competitive bidding in the auctions) as well as in the secondary market and introducing new products and instruments required for market development, including OTC and exchange-traded derivatives. Consequently, the government securities market has witnessed a significant transformation in its various dimensions, *viz.*, market-based price discovery, widening of the investor base, introduction of new instruments, establishment of primary dealers and electronic trading and settlement infrastructure.

*Infrastructure*

There is a comprehensive legal framework which defines the role of the Reserve Bank in the government securities market. As these instruments are listed on the stock exchanges and could be traded through stock exchange brokers, they also come under the regulatory ambit of SEBI to that extent. An element of self-regulation is in place through the Fixed Income Money Market and Derivatives Association of India (FIMMDA) and the Primary Dealers Association of India (PDAI), though they are not formally recognised as SROs.

Investment in government securities largely remains a wholesale market, though it is also open to individual investors. The investor base comprises banks, insurance companies, primary dealers, pension funds, other financial institutions and companies including debt funds set up by foreign institutional investors. Under the stipulations of the Fiscal Responsibility and Budget Management Act, 2003, the Reserve Bank has, since April 1, 2006, withdrawn from participating in the primary issues of government securities.

The first major initiative to develop the government securities market was the introduction of auctions which ensured that government borrowing was at market-related rates. Over time, the products have been diversified. In addition to regular fixed coupon securities, zero coupon bonds, floating rate bonds, capital indexed bonds and bonds with call and put options have been issued at various times.

In order to support primary auctions of government securities and improve secondary market liquidity, a system of market intermediaries in the form of Primary Dealers (PDs) was made functional in 1996.

Transparency was enhanced by the publication of a half-yearly issuance calendar for dated securities beginning in April, 2002. Dissemination of market information received an impetus when price information on trades was made available on the Reserve Bank's website on a real-time basis. Also, FIMMDA's website contains information about market yields on a daily basis. In a bid to keep the market liquid and active during bearish times, as also to allow market participants to better manage their interest rate risk, short-selling was allowed for a period of five trading days from January, 2007. To improve the price discovery process, a 'when–issued' (WI) market was introduced in 2006.

Government securities are traded electronically through NDS-OM[83] (NDS-Order Matching); this anonymous order-matching system that allows straight through processing (STP) was operationalised in August, 2005. The settlement cycle of the government securities market has been standardised to T+1 since 2005.

The government securities market has a robust infrastructure.

Almost the entire stock of government securities in value terms is held in the form of a dematerialised subsidiary general ledger (SGL). Secondary

[83] NDS-OM is Negotiated Dealing System – Order Matching.

market transactions settle through DVP-III where both funds and securities are settled on a net basis. CCIL acts as a clearing house and as a central counterparty through novation and guarantees settlement of trades.

In his budget speech of 2007-08, the Finance Minister made an announcement regarding separation of the debt management function from monetary management and the setting up of an autonomous Debt Management Office (DMO). In the first phase, a Middle Office has already been set up in the Ministry of Finance so as to facilitate transition to a full-fledged DMO.

*Growth and Composition*

Since the 1990s, there has been significant market growth in terms of both volume and liquidity (Table 4.6). The outstanding stock of government securities has increased significantly, both in absolute terms and in relation to GDP, in tandem with the growing financing requirements of the Government. The system of PDs has emerged as an important element, both in the primary and secondary market for government securities.

The outstanding amount of government securities witnessed a CAGR of 19.5 per cent between 1991-92 and 2007-08. The period was characterised by an elongation of the maturity profile along with a decline in cost of borrowings. The yields in government securities showed a decline until 2004, subsequent to which it showed an increasing trend till recently (Chart 4.5).

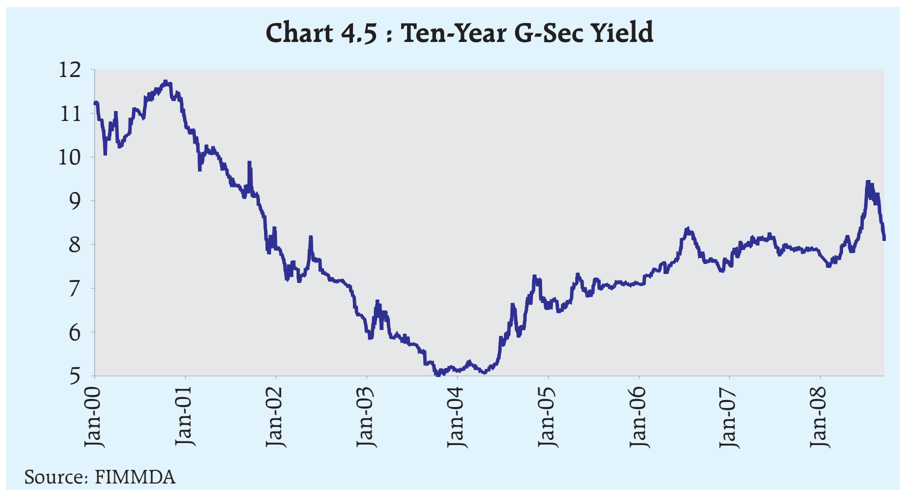
There has been significant growth in both volume and liquidity.

**Table 4.6: Government Securities Market – A Profile**

*Amount in Rs. crore; ratios in per cent*

| Indicator | 1991-92 | 1995-96 | 2000-01 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| Outstanding stock (in Rs. crore) | 76,908 | 1,69,526 | 4,53,668 | 8,24,612 | 9,29,612 | 10,32,296 | 13,32,435 |
| Outstanding stock/GDP (%) | 11.8 | 14.3 | 21.5 | 26.2 | 26.0 | 26.3 | 28.3 |
| Average maturity of securities issued during the year (in years) | .. | 5.7 | 10.6 | 14.1 | 14.1 | 16.9 | 14.9 |
| Weighted average cost of securities issued during the year (in per cent) | 11.8 | 13.8 | 11.0 | 6.1 | 7.3 | 7.9 | 8.1 |

**Source:** RBI



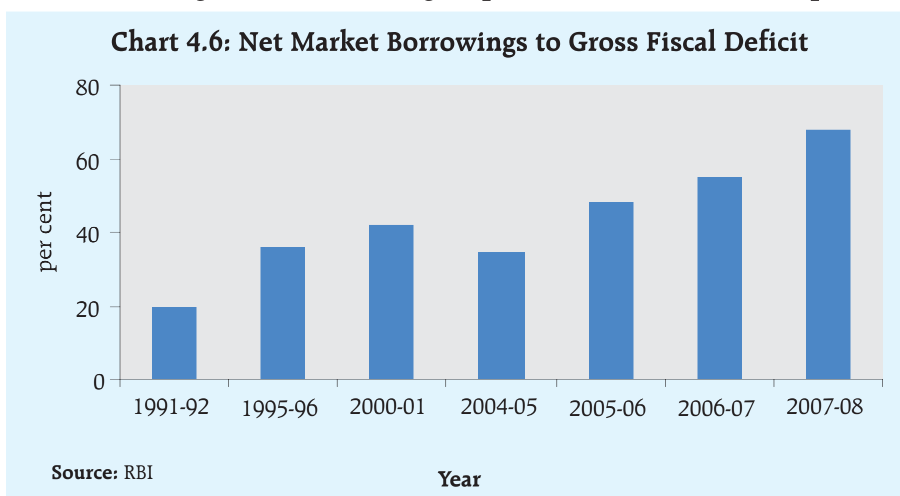

The yield curve in India has generally remained flat and has become flatter in recent years

With the phasing out of *ad hoc* Treasury Bills and earmarking of small savings collections for the States, the Central Government has been financing its deficits increasingly through market borrowings (Chart 4.6).

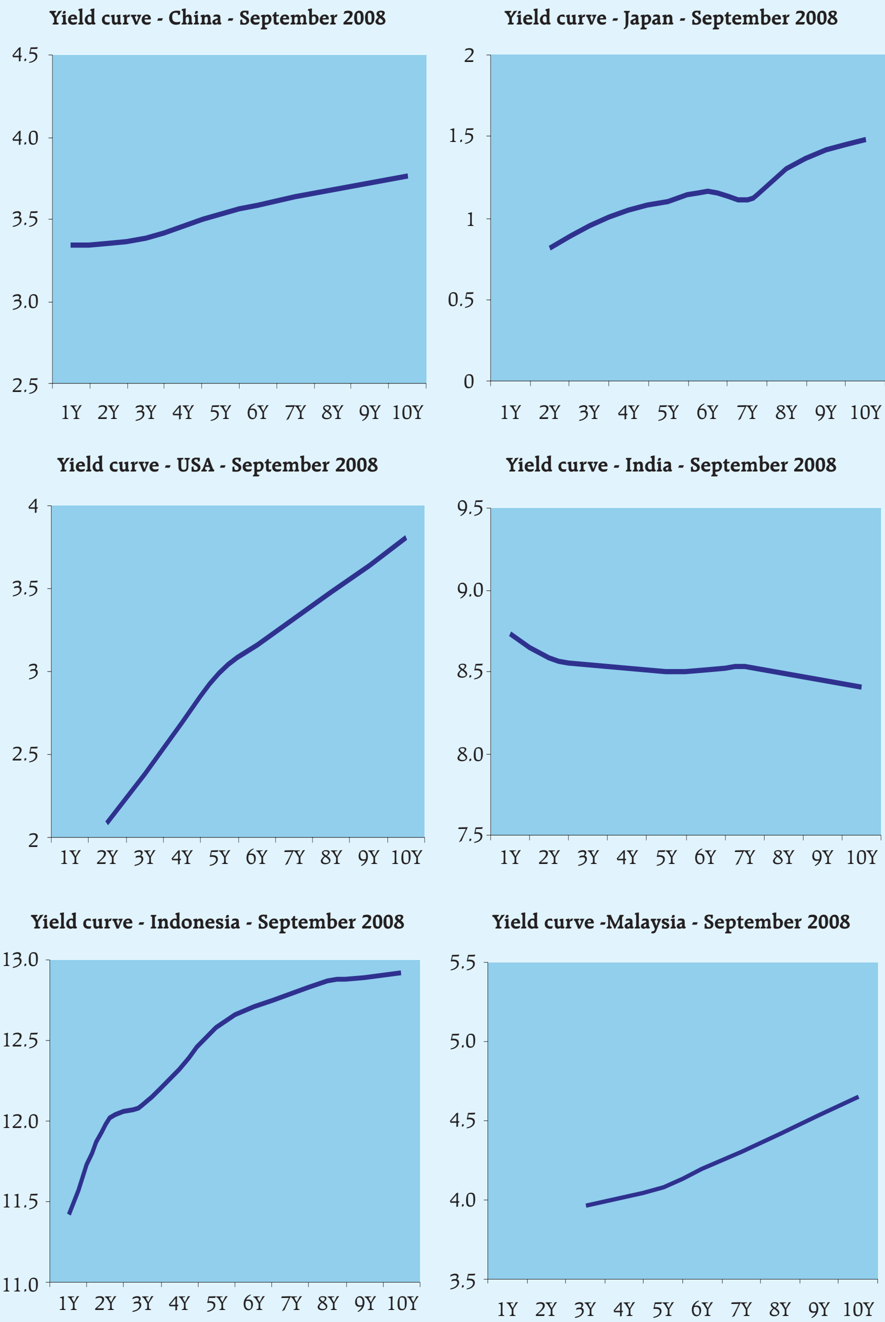
The yield curve in India has generally remained flat and has become flatter in recent years as evidenced from the declining 2-10 year spreads on Government Securities yields, from around 100 bps in 2001-02 to less than 40 on average in 2007-08. The flatness of the yield curve is also apparent when it is compared with the benchmark yields in other countries (Chart 4.7)

The Panel on Financial Stability Assessment and Stress Testing observes that the response to monetary policy has been quicker for short-term rates. Also, long-end yields declined faster during the period of low interest rates on account of active trading at the long end. The CFSA observes that the decline in spread between long-term and short-term yields could be the outcome of lower inflation expectation coupled with declining liquidity premium at the longer end of the yield curve.

An important hindrance to the development of the yield curve has been the lack of tradable assets. The regulatory accommodation (September 2004) of allowing banks to hold a higher portion of their investment portfolio




An important hindrance to the development of the yield curve has been the lack of tradable assets.




**Source:** Asian Development Bank (ADB) and FIMMDA

in the HTM category to immunise them from MTM losses in the increasing yield scenario, though taken in the interests of systemic stability and considering the SLR regime, has resulted in depletion of trading stock in the government securities market. As at end-March 2008, only a little under 30 per cent of the banks' holdings in government securities were in their trading books. On this account, banks could be carrying embedded losses in their investment portfolio which could be a cause for concern, though these could reverse in a favourable interest rate scenario**.** The CFSA feels that such regulatory prescriptions hamper trading in the government securities market and need to be removed.

### 4.4.1 Assessment of IOSCO Principles

Though the applicability of IOSCO principles to the government securities market is not very clear, the Panel considered the relevance and applicability of certain principles to the government securities market. The status of compliance to IOSCO principles in respect of this market as assessed by the Advisory Panel is summarised below.

The overall assessment shows that the number of principles which are fully implemented are 19, broadly implemented is 2, partly implemented are 5 and not applicable are 4. Thus, most of the applicable principles relating to responsibilities and powers of the regulator, enforcement, collective investment schemes, market intermediaries, secondary market and clearing and settlement systems are fully implemented. The principles relating to self-regulation, accounting and auditing standards and treatment of holders of securities are not applicable to the government securities market. Further, the principles relating to operational independence and accountability; co-operation; disclosure of financial results and procedure for dealing with failure of market intermediary are not fully implemented (Table 4.7).

With a view to achieve convergence to IOSCO principles in areas where some gaps have been observed, the Advisory Panel has made appropriate recommendations. The issues and concerns along with recommendations emanating from the assessment of the Panel on Financial Stability Assessment and Stress Testing are provided in the next section.

### 4.4.2 Issues and Concerns

#### 4.4.21 Market Intermediaries

At present, the risks underlying the trading/financial position of the PDs are not disclosed by the regulator. Given the sensitive nature of the information, the Panel on Financial Regulation and Supervision feels that there may be a need for disclosing the PD's trading/financial position with a sufficient time lag, subject to assessing its impact on systemic stability. The CFSA is of the view that while transparency strengthens market discipline, circumspection in disclosures by the supervisors may be required because of the potential market reaction that it might trigger, which may not be desirable. The Reserve Bank may form a view in this regard.

**Table 4.7: Summary Assessment of Government Securities Market**

| Principle | Status of Compliance | | | |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| **Principles of regulator** | | | | |
| 1. Responsibilities of regulator | FI | | | |
| 2. Operational independence and accountability | | | PI | |
| 3. Power, resources and capacity to perform functions | FI | | | |
| 4. Regulatory processes of regulator | FI | | | |
| 5. Professional standards of staff of regulator | FI | | | |
| **Principles relating to self regulation** | | | | |
| 6. Regulatory regime | | | | NA |
| 7. Regulators' oversight over SROs and standards adopted by SROs | | | | NA |
| **Principles relating to enforcement** | | | | |
| 8. Inspection, investigation and surveillance powers | FI | | | |
| 9. Enforcement powers | FI | | | |
| 10. Use of inspection, investigation, surveillance and enforcement powers | FI | | | |
| **Principles relating to co-operation** | | | | |
| 11. Authority to share information with domestic and foreign counterparts | | | PI | |
| 12. Information-sharing mechanisms | | | PI | |
| 13. Assistance provided to foreign regulators | | | PI | |
| **Principles relating to issuers** | | | | |
| 14. Disclosure of financial results | | | PI | |
| 15. Treatment of holders of securities | | | | NA |
| 16. Accounting and auditing standards | | | | NA |
| **Principles relating to collective investment scheme** | | | | |
| 17. Standards for eligibility and regulation | | BI | | |
| 18. Rules governing legal form and structure | FI | | | |
| 19. Disclosure requirements | FI | | | |
| 20. Asset valuation and pricing and redemption of units | FI | | | |
| **Principles relating to market intermediaries** | | | | |
| 21. Minimum entry standards | FI | | | |
| 22. Capital and prudential requirements | FI | | | |
| 23. Internal organisation and operational conduct | FI | | | |
| 24. Procedure for dealing with failure of market intermediary | | BI | | |
| **Principles relating to secondary markets and clearing and settlement** | | | | |
| 25. Trading systems | FI | | | |
| 26. Regulatory supervision | FI | | | |
| 27. Transparency of trading | FI | | | |
| 28. Detection of manipulation and unfair trading practices | FI | | | |
| 29. Management of large exposures, default risk and market disruption | FI | | | |
| 30. Systems for clearing and settlement of securities | FI | | | |
| **Total** | **19** | **2** | **5** | **4** |

FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable

**Source:** Advisory Panel on Financial Regulation and Supervision.

#### 4.4.22 Trading Platforms

So far, the only trading system in India dedicated to the government securities market is owned by the Reserve Bank itself and managed by the Clearing Corporation of India Ltd. (CCIL). There is a view that given the fact that the Reserve Bank manages public debt and also regulates the government securities market, owning the trading platforms increases the possibility of conflict of interest. The Panel on Financial Regulation and Supervision recommended that trading platforms should be hived off from the Reserve Bank in a phased manner. The CFSA feels that the Reserve Bank could take a considered view on the matter.

A view requires to be taken on hiving of trading platforms from the Reserve Bank ownership.

#### 4.4.23 Transparency and Disclosure

Given the calibrated movement towards fuller capital account convertibility and the increased need for foreign funds to develop social overhead capital, the Panel on Financial Regulation and Supervision felt that Central/State Governments can consider reducing the time lag in publication of audited financial results and increase the frequency of financial disclosures so that government debt can be appropriately rated. This would make government-issued paper more attractive to the international investor. In this context, the CFSA notes that from 2006-07 onwards, audited annual accounts of the Central Government are presented with a time lag of about 6 to 9 months.

In a similar vein, the Panel on Financial Stability Assessment and Stress Testing observes that, with fuller capital account convertibility, the investment in government securities by foreign entities would also require strengthening disclosure requirements. This is because with gradual progress towards fuller capital account convertibility, Indian government bonds could be progressively accessed by prospective international investors. The CFSA feels that though increased transparency and disclosure standards are desirable objectives in respect of sovereign debt instruments, they may not be easy to implement and hence need to be viewed independently of the issue of capital account convertibility.

A move to accrual accounting and accrual budgeting has to be phased

Similarly, in the case of accrual-based accounting for the Government, while some elements could be adopted, full accrual-based accounting may not be possible in the near future. The issue needs to be pursued after clearly establishing the related benefits and developing the required skills[84] and would be assessed by the 13$^{th}$ Finance Commission[85].

The issue of opening foreign investment to government securities, both central and state, has to be approached with great care and caution. Much greater improvement has to take place in the Indian fiscal situation before the country is exposed to external exposure of its sovereign debt. The CFSA does not recommend such opening at the present time.

Improvement has to take place in fiscal situation before India is exposed to external exposure of its sovereign debt.

[84] Please see Chapter 6, Section IV on Fiscal Transparency for a more detailed consideration by the CFSA.
[85] This issue has been considered in greater detail in Chapter 6 (Section 6.3.3(d)(i)).

**4.4.24 Further steps for Market Development**

The Advisory Panel on Financial Stability Assessment and Stress Testing has recommended certain measures for the development of the cash and derivatives markets:

- Scaling down mandated investments in government securities and introducing AS 30 (requiring banks to recognise both MTM gains and losses in their trading book as also letting banks charge depreciation in the AFS category to the equity account) would result in an increase in tradable assets. This would help development of the risk-free yield curve across maturities through active secondary market trading.
- The CFSA notes that the Banking Regulation Act was amended in 2006 *inter alia* empowering the Reserve Bank to prescribe the Statutory Liquidity Ratio. At the same time it feels that any reduction in SLR should factor in the pressure of expenditure and consequent fiscal deficit, as well as market borrowings under the Market Stabilisation Scheme (MSS) given the fact that the SLR requirement prescribed for banks enables smooth conduct of the government's borrowing programme. The SLR needs therefore, to be equally viewed as a prudential requirement to sustain the liquidity position of banks. Further, a reduction in SLR could increase the possibility of the banks being saddled with more illiquid and low quality assets. Also, there is a need to find alternate sets of investors in government securities that would buttress the demand for such instruments. Any reduction in SLR requests has to take into account the prudential role of SLR on banks' balance sheets.
- Consequent to the phased reduction in SLR and other statutory pre-emptions, there is a need to diversify the investor base to the non-bank and retail segments. Broadening the investor base by developing retail and mid-segment long-term investors would also make the market more diverse and less unidirectional.
- Need to develop new instruments like inflation indexed bonds.
- Development of Separate Trading of Registered Interest and Principal of Securities (STRIPS).

There is a need to diversify the investor base to non-bank and retail segments.

**4.4.25 Derivatives Segment**

The Panel underscores the necessity of the availability of varied hedging instruments for effective mitigation of interest rate risk across the

gamut of market participants. At the same time it recognises that capacity building to avoid the lack of understanding of a derivative product's suitability and appropriateness is a must. In the case of the derivatives segment, it is further of the view that exchange traded derivatives like interest rate futures should be introduced at an early date

Interest Rate Futures should be introduced at an early date.

The CFSA agrees with the broad thrust of the recommendations made by the Panel and recognises that many of the recommendations are already under implementation by the Reserve Bank. It also feels that the settlement of all OTC derivatives should be routed through a clearing corporation.

**4.4.26 Liquidity of State Government Paper**

Though state government securities constitute around 16 per cent of the total outstanding government securities, their share in traded volume is only around 3 per cent. Given the discontinuation of the Central Government's loans for State Plans, it may require an increase in States' recourse to market borrowings. Enhanced liquidity could minimise the state government's borrowing costs. In order to activate secondary market activity in state government securities, the recommendations of the Working Group on Liquidity of State Government Securities may be considered for implementation.

**4.4.27 Self-regulatory Organisations**

Though some self-regulatory functions are performed by FIMMDA/ PDAI, these organisations are not designated SROs. Along with the Panel on Financial Stability Assessment and Stress Testing, the Panel on Financial Regulation and Supervision has also recommended consideration of FIMMDA as an SRO[86].

**4.4.28 Short-selling and 'When Issued' (WI) Markets**

The activity in WI and short selling markets is yet to throw up the desired results. The Panel on Financial Stability Assessment and Stress Testing recommends that there is a need to gradually increase the number of trading days for short selling in government securities from five. Also, in both the case of short selling and WI markets, since securities are mandated to be invariably delivered on the settlement date, there is a need for appropriate borrowing/lending mechanisms in government securities to be in place.

The CFSA is of the view that the Reserve Bank may consider the recommendations of the Panel with sufficient safeguards to address the inherent risks.

There needs to be appropriate borrowing/lending mechanisms in government securities with sufficient safeguards.

**4.4.3 Summary**

Since the 1990s, there has been significant growth of the government securities market, in terms of both volume and liquidity, thanks to various measures taken to develop the market infrastructure in terms of the appropriate legal framework to enhance regulatory clarity, gradually broaden

[86] The CFSA's detailed views in this regard are elaborated in Chapter 5 in the section on SRO.

the investor base, introduce auctions and put in place a system of primary dealers who acted as market intermediaries. Enhancement of transparency, creation of trade associations like FIMMDA, which also aided in market development, and improvements in trading and settlement systems are other developments in the government securities market.

The outstanding amount of government securities grew at a rate of 19.5 per cent per annum between 1991-92 and 2007-08. The yield curve in recent years has remained flat, which could be the outcome of lower inflation expectation coupled with declining liquidity premium at the longer end of the yield curve. One hindrance to the development of the yield curve has been the lack of tradable assets with banks, with only little around 30 per cent of the total government securities being in the trading book.

Though the applicability of IOSCO principles to the government securities market is not clear and some of the principles are not relevant to the government securities market, an assessment of this market with IOSCO principles revealed that there are regulatory gaps in relation to operational independence and accountability of the regulator; regulatory co-operation; disclosure of financial results; and procedure for dealing with failure of a market intermediary.

So far, the only trading system in India dedicated to the government securities market is owned by the Reserve Bank and managed by the Clearing Corporation of India Ltd. (CCIL). The trading platforms could be hived off from the Reserve Bank in a phased manner.

Though increased transparency and disclosure standards are desirable objectives, sovereign debt issues cannot be compared with issues of private debt and equity instruments. Accrual-based accounting for the Government also needs to be pursued after clearly establishing the related benefits and the development of required skills and this would be examined by the 13th Finance Commission.

The issue of opening foreign investment to government securities, both central and state, has to be approached with great care and caution. Much greater improvement has to take place in the Indian fiscal situation before the country is exposed to external exposure of its sovereign debt.

The following measures can be considered for development of the government securities market.

- Scaling down of mandated investments in government securities and introduction of AS 30 would result in an increase of tradable assets.

Such a reduction, however, needs to be done with care taking into account the prudential role of SLR on bank's balance sheets. As reduction in SLR could have implications for the Government in raising resources to finance its fiscal deficit, there is a need to diversify the investor base to non-banks and retail segments.

- Development of Separate Trading of Registered Interest and Principal of Securities.
- Availability of varied hedging instruments for effective mitigation of interest rate risk across the gamut of market participants.
- Gradually increasing the number of trading days for short selling in government securities from five, along with appropriate borrowing/lending mechanisms in government securities.
- Capacity building to study the suitability of a derivative product and its appropriateness.
- Encouraging exchange traded derivative products and recording/settlement of all OTC derivatives through a clearing corporation
- The recommendations of the Working Group on Liquidity of State Government Securities need to be considered for implementation to activate the secondary market.

## 4.5 Money Market

The important components of the money market in India are inter-bank call (overnight) money, market repo, collateralised borrowing and lending obligation (CBLO)[87], Commercial Paper (CP), Certificates of Deposit (CD) and term money markets. Treasury bills constitute the main instrument of short-term borrowing by the Government and serve as a convenient gilt-edged security for the money market. Historically, the call money market has constituted the core of the money market in India. However, the collateralised segments, *viz.*, market repo and CBLO, have come into prominence recently.

*Infrastructure*

Trading in money market instruments can take place on a trading platform or in the OTC market. Electronic platforms are available for deals in the call, notice and term money market transactions, market repo and CBLO.

[87] Collateralised Borrowing and Lending Obligation (CBLO), a money market instrument as approved by the Reserve Bank, is a product developed by CCIL for the benefit of entities who have either been phased out from the inter-bank call money market or have been given restricted participation in terms of ceiling on call borrowing and lending transactions and who do not have access to the call money market. CBLO is a discounted instrument available in electronic book entry form for a maturity period ranging from one day to ninety days (can be made available up to one year as per Reserve Bank guidelines).
CBLO is explained as under:

- An obligation by the borrower to return the money borrowed, at a specified future date;
- An authority to the lender to receive money lent, at a specified future date with an option/privilege to transfer the authority to another person for value received;
- An underlying charge on securities held in custody (with CCIL) for the amount borrowed/lent.

Relative importance of call money in the overnight segment has been declining.

OTC deals are done for Commercial Paper (CP) and Certificate of Deposit (CD), as well as for call/notice/term money markets. Settlement is done over the Real Time Gross Settlement system – either as a gross settlement or as a multilateral netted batch. CP and CD deals, which are mostly in the form of private placements, are done OTC.

The Reserve Bank's regulatory powers over money market securities have gained clarity through a government notification under Section 16 of the SC(R) Act. This was further strengthened under Clause 45 (W) of the RBI Amendment Act, 2006, wherein the Reserve Bank has been given specific powers to 'regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products, and give directions on that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time'.

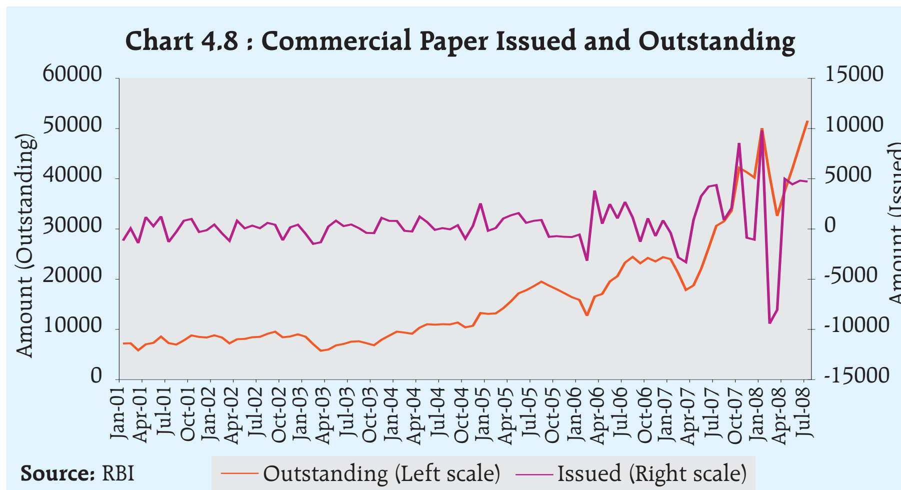
*Growth and Composition - Cash Segment*

The market structure is broad-based with the participation of banks, primary dealers, insurance companies, mutual funds, provident funds, and corporates. Such a broad participation has contributed to an active interest across market segments. The Reserve Bank has further been focusing on the growth of the collateralised market, limiting call money market participation to only inter-bank.

The relative importance of call money as an instrument for institutions to tide over overnight mismatches has been declining and call money in 2007-08 constitute only about 20 per cent of the total overnight transactions compared to 100 per cent in 1997-98. The shares of market repos and CBLO are growing in tandem and stood at 39.8 per cent and 40.4 per cent, respectively, in 2007-08 (Chart 4.8). There has been a significant increase in outstanding commercial paper (CP) and certificates of deposit (CDs) over the past three years. While the increase in outstanding CP could be attributed to the ample availability of liquidity and industrial buoyancy, the sharp rise in CDs was a result of efforts taken by banks to mobilise deposits to fund their credit growth. The term money market turnover remains insignificant.

The Indian money market has generally been liquid.

The Indian money market has generally been a liquid market (based on overnight data on bid-ask spread from April 1, 2004 to November 25, 2008). Excluding outliers, the bid-ask spread varied between 4 and 69 bps with an average of 18 bps and standard deviation (SD) of 17 bps (coefficient of



**Source:** RBI

variation is 95.6 per cent) during the period. The gradual shift towards a collateralised inter-bank market, phasing out of non-bank participants from the call money market, policy directions towards reductions in statutory reserve requirements, introduction of new instruments such as CBLO, implementation of RTGS, significant transformation of the monetary operations framework towards market-based arrangements (also observed by the peer reviewer, Mr Sundararajan) and facilitation of trading through NDS-CALL are some of the factors that have contributed to the development of a relatively vibrant and liquid money market.

Also, since the introduction of financial market reforms there has been a significant decline in volatility in the money market. This could be attributed to softening of rates, reduction in inflation expectations, introduction of LAF and setting up of an informal corridor of overnight rates, and the introduction of new instruments like market repo and CBLO. The lower volatility, which is a function of stable market expectations, is in consonance with the Reserve Bank's emphasis on maintaining orderly market conditions.

*Growth and Composition - Derivatives Segment*

While interest rate deregulation has made financial market operations more efficient and cost-effective, it has also exposed participants to increased risks. Interest rate derivative products could be an effective risk mitigant in this regard. Rupee derivatives in India were introduced when the Reserve Bank permitted banks/FIs/PDs to undertake Interest Rate Swaps/Forward Rate Agreements in July 1999, of which interest rate swaps (IRS) are the predominant instrument.

OIS market has been very active.

While the swap market, especially the Overnight Indexed Swaps (OIS) market, has been very active in India and used by banks as well as other entities to manage their interest rate risk more than any other instrument, the absence of a term money market and therefore a 3- or 6-month benchmark rate has led to entire market concentration on the overnight benchmark. The notional principal outstanding for commercial banks in respect of Interest

Rate Swaps has increased from Rs.10,81,867 crore as on March 31, 2005 to Rs.80,18,647 crore as on March 31, 2008.

Trades in the swap market are over-the-counter (OTC). Inadequate transparency in this market has prompted the Reserve Bank to introduce a reporting mechanism from August 30, 2007. This is expected to improve pricing transparency and, consequently, the volumes significantly. A Working Group constituted by the Reserve Bank to recommend measures to facilitate development of a robust Interest Rate Futures market for management of interest rate risk has examined ways of activating interest rate futures.

#### 4.5.1 Assessment of IOSCO principles

The Advisory Panel on Financial Regulation and Supervision considered the relevance and applicability of certain IOSCO principles to the money market. The status of compliance to IOSCO principles in respect of the money market as assessed by the Advisory Panel is summarised below.

The assessment overall shows that the number of principles which are fully implemented are 19, broadly implemented are 4, partly implemented are 5 and not applicable are 2. Thus, most of the applicable principles are fully implemented. The assessment has revealed that the principles relating to operational independence and accountability; co-operation; minimum entry standards, capital and prudential requirements; and procedure for dealing with failure of market intermediary are not fully implemented (Table 4.8). The issues and concerns along with recommendations emanating from the assessment of the Panel are covered in Section 4.5.2.

#### 4.5.2 Issues and Concerns

#### 4.5.21 Term Money Market

The term money market has not developed and remains inactive

Despite a number of initiatives taken by the Reserve Bank, the term money market has not developed and remains inactive due to the inability of market participants to take a medium-term view on interest rates and liquidity, the absence of a credible benchmark, skewed distribution of market liquidity, corporates' preference for 'cash credit' over other modes of loan disbursements, and a tendency on the part of banks to deploy their surplus funds in LAF auctions rather than in the term money market. This has been also one of the reasons for non-emergence of a short-term yield curve. The Advisory Panel on Financial Stability Assessment and Stress Testing has suggested the development of longer-term benchmarks other than overnight rates, which could be achieved by phasing out cash credit and giving

| Table 4.8: Summary Assessment of Money Market | | | | |
|---|---|---|---|---|
| **Principle** | **Status of Compliance** | | | |
| 1 | 2 | 3 | 4 | 5 |
| **Principles of regulator** | | | | |
| 1. Responsibilities of regulator | FI | | | |
| 2. Operational independence and accountability | | | PI | |
| 3. Power, resources and capacity to perform functions | FI | | | |
| 4. Regulatory processes of regulator | FI | | | |
| 5. Professional standards of staff of regulator | FI | | | |
| **Principles relating to self regulation** | | | | |
| 6. Regulatory regime | | | | NA |
| 7. Regulators' oversight over SROs and standards adopted by SROs | | | | NA |
| **Principles relating to enforcement** | | | | |
| 8. Inspection, investigation and surveillance powers | FI | | | |
| 9. Enforcement powers | FI | | | |
| 10. Use of inspection, investigation, surveillance and enforcement powers | FI | | | |
| **Principles relating to co-operation** | | | | |
| 11. Authority to share information with domestic and foreign counterparts | | | PI | |
| 12. Information-sharing mechanisms | | | PI | |
| 13. Assistance provided to foreign regulators | | | PI | |
| **Principles relating to issuers** | | | | |
| 14. Disclosure of financial results | FI | | | |
| 15. Treatment of holders of securities | FI | | | |
| 16. Accounting and auditing standards | FI | | | |
| **Principles relating to collective investment scheme** | | | | |
| 17. Standards for eligibility and regulation | | BI | | |
| 18. Rules governing legal form and structure | FI | | | |
| 19. Disclosure requirements | FI | | | |
| 20. Asset valuation and pricing and redemption of units | FI | | | |
| **Principles relating to market intermediaries** | | | | |
| 21. Minimum entry standards | | BI | | |
| 22. Capital and prudential requirements | | BI | | |
| 23. Internal organisation and operational conduct | | | PI | |
| 24. Procedure for dealing with failure of market intermediary | | BI | | |
| **Principles relating to secondary markets and clearing and settlement** | | | | |
| 25. Trading systems | FI | | | |
| 26. Regulatory supervision | FI | | | |
| 27. Transparency of trading | FI | | | |
| 28. Detection of manipulation and unfair trading practices | FI | | | |
| 29. Management of large exposures, default risk and market disruption | FI | | | |
| 30. Systems for clearing and settlement of securities | FI | | | |
| **Total** | **19** | **4** | **5** | **2** |

FI- Fully implemented, BI-Broadly implemented, PI-Partly Implemented, NI-Not Implemented, NA- Not applicable

**Source:** Advisory Panel on Financial Regulation and Supervision.

regulatory incentives to lending institutions to provide short-term loans to corporates.

The CFSA, while appreciating the concerns in regard to development of the term money market, would not advise a prescriptive approach to selective regulatory incentives for specific instruments. These are essentially commercial decisions and are best left to banks. More importantly, the

There is a case for permitting banks to take trading positions in the IRF market as they are already allowed in OTC swap market.

systemic implications of any borrowing/lending patterns need to be carefully studied.

The CFSA recognises, however, the need for developing the term-money market, which would be facilitated by the development of an active futures market with the underlying beyond the overnight tenor at present. There is a case for permitting banks to take trading positions in the IRF market as they are already allowed in OTC swap market. Also, short selling of all kinds of money market securities could be allowed in a phased manner.

The CFSA feels that money markets are an extremely important channel for monetary policy transmission in the economy. Market development measures, though extremely important, need to ensure that these do not induce seeds of systemic instability in future. Any further reform measures should be preceded by a potential impact analysis.

The Advisory Panel on Financial Stability Assessment and Stress Testing felt that the Reserve Bank may consider re-introduction of long-term LAF and also introduce a term liquidity facility in the form of a general refinance facility subject to prudential safeguards. The CFSA has some reservations on introducing term liquidity facility under normal market conditions[88].

The CFSA feels that the Reserve Bank could consider the views of the Panel.

**4.5.22 Market Repo**

Pool of eligible securities for market repo could be more broad based.

With the access to call money being restricted in respect of non-banks, there has been an increase in market repo where the average daily turnover saw a five-fold increase between 2000-01 and 2007-08. Currently, market repo is allowed only in respect of government securities. In order to develop the repo market further, the pool of eligible securities could be broad-based by allowing AAA-rated corporate bonds to be repo-able, with appropriate haircuts, if required. This would also require a reasonably well-developed corporate bond market along with a transparent and efficient clearing and settlement system which, in turn, could facilitate the induction of corporate bonds in the pool of eligible securities.

The CFSA feels that the Reserve Bank could consider the views of the Panel.

[88] The CFSA view in this regard is elaborated in Chapter in the section on liquidity infrastructure.

#### 4.5.23 Self-Regulatory Organisation

Both Panels on Financial Stability Assessment and Stress Testing and Regulation and Supervision have suggested that FIMMDA could be considered as an SRO for the money market[89].

FIMMDA could be considered as SRO for government securities and money market.

#### 4.5.24 Commercial Paper

Though it is not obligatory on the part of financial institutions to provide any 'stand-by' facility to issuers of corporate papers, the existence of an appropriate liquidity back-up is imperative to mitigate risks in the commercial paper market. All corporate papers should be rated keeping in view the availability of appropriate liquidity back-up. In the interests of market discipline, the Panel further recommended the disclosure of the nature of liquidity back-up by the issuers in their prospectus to prevent liquidity and other contagion risks.

CFSA feels that the recommendation can be considered by the Reserve Bank.

### 4.5.3 Summary

The Reserve Bank's regulatory powers over money market securities have gained clarity through a Government notification under Section 16 of the SC(R) Act which was further strengthened under Clause 45 (W) of the RBI Amendment Act, 2006. The relative importance of call money as an instrument for institutions to tide over overnight mismatches has been declining, while the share of market repos and CBLO are growing in tandem. The Indian money market has generally conformed to being a liquid market with a low and stable bid-ask spread. Better trading and settlement infrastructure coupled with the introduction of financial market reforms have led to a decline in money market volatility. In the derivatives segment, the swap market (especially OIS) has been the active segment.

The assessment with IOSCO principles has revealed that regulatory gaps exist in respect of operational independence and accountability; regulatory co-operation; minimum entry standards, capital and prudential requirements; and procedure for dealing with failure of market intermediaries.

All corporate papers should be rated keeping in view the availability of appropriate backup.

The term money market has not developed and remains inactive. However, a prescriptive approach for selective regulatory incentives in respect of specific instruments may not be appropriate and such decisions should best be left to banks. An active interest rate futures market would facilitate the development of the term money market. There is also a case for permitting banks to take trading position in respect of Interest Rate Futures (IRF) to develop the IRF market. Also, short selling of all types of money market securities could be allowed in a phased manner. The Advisory Panel on

[89] The CFSA view in this regard is elaborated in Chapter 5, section 5.2.3 on SROs.

Financial Stability Assessment and Stress Testing felt that the Reserve Bank may consider the re-introduction of long-term LAF, but the CFSA does not support the idea of a term liquidity facility in the form of a general refinance facility under normal market conditions. Market development measures, though extremely important, need to ensure that they do not induce seeds of systemic instability in future. Any further reform measures should be preceded by a potential impact analysis.

In the interests of market development, broad-basing market repo by allowing AAA-rated corporate bonds to be repo-able with appropriate haircuts can be considered. FIMMDA could be accorded SRO status. Given the problems faced with CPs in global markets, all corporate papers should be rated keeping in view the availability of appropriate liquidity back-up. In the interests of market discipline, disclosure of the nature of liquidity back-up by the issuers in their prospectus to prevent liquidity and other contagion risks should be considered.

## 4.6 Development of Other Market Segments

At a time when India is endeavouring to sustain its growth rate, it becomes imperative to remove financing constraints so that alternate financial channels can be developed in a systematic manner to supplement bank credit. With the judicious opening up of capital account as a tool that could be utilised to help create investor demand, the expeditious development of the corporate bond market and credit market requires to be viewed from this standpoint.

### 4.6.1 Corporate Bond Market

The economic buoyancy in India combined with the enhancement in financial infrastructure in the form of well-developed trading, clearing and settlement systems have contributed to rapid growth in the equity market. In the debt market, reforms in issuance procedures and trading and settlement mechanisms combined with the burgeoning borrowing requirements of the Government contributed to a vibrant growth in the government securities market. Compared to these, for a variety of reasons, the corporate bond market has not witnessed a similar growth and vibrancy. The need to strengthen this market is keenly felt in the context of financing the long-term needs of corporates by adequately leveraging risk capital as well as an alternate source of funding for the widening gap in infrastructure investments.

**4.6.11 Development Issues**

The corporate debt market is not yet large enough to have a significant impact on systemic stability. The Indian financial system is dominated by bank intermediation. Corporates in India have traditionally relied on borrowings from banks and financial institutions. Equity financing has also been used during periods of surging equity prices. The corporate bond market, which was reasonably vibrant in the mid-eighties, has however shrunk with respect to its alternate sources of funding. The lack of buying interest, low transparency and absence of pricing of spreads against the benchmark – a flat yield curve – are some of the other reasons. The opening up of the capital account could, however, see the growth of the corporate bond market as there may be demand from foreign investors seeking exposure to high-quality corporate debt.

Even on the supply side, the need for the corporate bond market by the corporates is inadequate. This is due to their increased access to the off-shore market and improving off-shore spreads/risk perception resulting in greater liquidity off-shore rather than on-shore. Further, a sizable market is captured by the large issuance of credit risk-free government securities and issuance of low-risk subordinated debts at attractive interest rates by banks as part of their Tier II capital. While SEBI has initiated steps to simplify issuance procedures and reduce the costs of public issuance, the relative ease in raising corporate debt through private placements has resulted in the large share of private placement issuance of corporate bonds. This has rendered the corporate bond market relatively less transparent which has, in turn, impacted the liquidity of such bonds.

The secondary market in corporate bonds is limited to highly rated securities (AA and above). The wholesale debt segments of the stock exchanges have not picked up and the OTC market in corporate bonds lacks an automated order matching system and centralised settlement. The absence of DVP is another obstacle in market development. The tax deducted at source (TDS) system for corporate bonds acts as an impediment to the development of secondary market activities, especially since government securities are not subject to TDS. The delay in contract enforcement also hampers market development.

Mr. Andrew Sheng, peer reviewer, is of the view that the lack of buyers could be due to the lack of centralised transparency and the lack of pricing of spreads against the benchmark yield curve. He observes that only when there is a large pension fund market and the risk spreads are attractive will the corporate bond market grow strongly from demand. The current corporate risk spreads may not totally reflect risks and, therefore, would not attract demand.

Large share of private placement have made the corporate bond market less transparent.

The Panel on Financial Stability Assessment and Stress Testing has recommended various measures to develop the corporate bond market, which can be broadly segregated into regulatory reforms and legislative and judicial

reforms. The major recommendations are enumerated below. The CFSA endorses the Panel's recommendations and suggests that the authorities could consider appropriate measures as under, in an urgent manner.

**4.6.12 Regulatory Measures**

- Corporate bonds could be made repoable in a phased manner. To begin with, it may be permitted for AAA-rated corporate bonds only for market repos and could subsequently be extended to other highly rated bonds (AA and above). Eventually, the facility of repo could be considered to be extended to LAF.
- Consolidation of all trades reported in different reporting platforms could be disseminated through SEBI or any other centralised agency to enhance transparency. The CFSA notes that this has already been introduced by FIMMDA.
- Expediting development of hedging instruments like credit default swaps could be considered. To enhance liquidity in credit default swap markets, shorting within specified limits for banks and primary dealers could be allowed taking into account recent developments in international financial markets.
- There could be further simplification of the debt issuance process and phased movement towards anonymous order matching trading systems, if there is a demand from the market.
- There is an urgent need for introduction of DVP in corporate bonds as well as ensuring that the settlement takes place through a clearing corporation. There should be some rebalancing in favour of corporate bonds. In this context, reduction of mandated investments in respect of insurance companies could be explored.
- The parallel development of the government securities market, the term money markets and related derivatives is necessary to establish a risk-free yield curve that would facilitate the pricing of corporate bonds.

Various regulatory and legislative measures are required to activate the corporate bond market.

**4.6.13 Legislative and Judicial Reforms**

- Rationalisation of stamp duty has been taken up by SEBI with the Government and requires to be expedited.
- There is a need to abolish TDS in corporate bonds as this would bring corporate bonds at par with government securities and facilitate secondary market trading. The process could be initiated in a phased manner by covering municipal bonds/infrastructure bonds in the first

phase before taking it forward to cover the entire corporate bond segment. This has been announced in the Budget of 2008-09 but needs to be expedited.

- The Pension reform bill when passed will pave the way for pension funds to invest in corporate bonds.
- Similarly, there is also a need for reform in the insurance sector.
- Timely, efficient and effective bankruptcy laws are a key underpinning to the development of the corporate bond market.

Mr. V. Sundararajan, peer reviewer, has observed that the development of the corporate bond market would be a key reform to foster infrastructure development and growth. Hence, he recommends that a careful prioritisation and sequencing of the needed measures may be undertaken and in particular, reforms that would take time to implement must start early, such as the strengthening of the corporate bankruptcy regime. At the same time, he suggested that the opening up of the market to foreign investors and issuers, with suitable prudential safeguards, could go a long way to expedite the development of this market. The CFSA is of the view that sequencing the strengthening of the corporate bankruptcy regime before other steps could delay the development of the corporate bond market and this could be attempted in parallel with other measures.

The issue of opening up the corporate debt market to foreign investors also has to be approached with caution. As long as there is a significant difference between Indian and international inflation rates, and hence interest rates, without corresponding expectations related to the evolving exchange rate, opening the Indian debt market to foreign investment can raise issues of financial stability.

#### 4.6.2 Credit Derivatives

The credit market refers to the market where financial instruments that embrace credit risk are traded. In addition to traditional instruments, such as loans and advances, corporate bonds, and CP, the credit market now includes securitised products in which various credit risks have been pooled as well as credit derivatives whose underlying assets encompass credit risks.

As a financial system which is dominated by bank intermediation, credit has traditionally been the main source of funds to various sectors in the Indian economy, and loans and advances continue to be the preferred part of banks' asset books. However, the implementation of risk management guidelines and the requirement for providing a capital charge for credit risk[90]

Opening up of the corporate debt market to foreign investors has to be approached with caution.

[90] The Basel Accord, introduced in 1998, primarily focussed on credit risk. Assets of banks were classified and grouped into five categories based on their credit risk and accordingly carried varied risk weights. Banks with international presence were required to hold capital equal to 8 % of the risk-weighted assets. The Basel II Accord, introduced in 2004, requires the credit risk component to be calculated in three different ways with varying degrees of sophistication, namely, the standardised approach, Foundation Internal Ratings-Based Approach (F-IRB) and Advanced IRB. Basel II has issued detailed guidelines on capturing risk in capital, emanating from instruments of credit risk transfer, like securitisation and credit derivatives.

in the balance sheet has given banks an incentive to look for innovative methods of transferring credit risk from their books.

While simple techniques for transferring credit risk, such as financial guarantees, collateral and credit insurance have long been prevalent in the Indian banking industry, the recent innovative instruments in credit risk transfer are yet to make an impact.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 provided for sale of financial assets by banks/FIs to securitisation/reconstruction companies. Thereafter, in order to ensure the healthy development of the securitisation market, draft guidelines for securitisation of standard assets were issued in 2005, followed by draft guidelines on the sale/purchase of non-performing assets.

The Reserve Bank in its Annual Policy announced in April 2007 mentioned that, as part of the gradual process of financial sector liberalisation in India, it was considered appropriate to introduce credit derivatives in a calibrated manner at this juncture. The risk management architecture of banks had been strengthened and banks were on their way to becoming Basel II-compliant, providing adequate comfort levels for the introduction of such products. Furthermore, the amendment to the Reserve Bank of India Act, 1934 had provided legality to OTC (over-the-counter) derivative instruments, including credit derivatives.

Against this backdrop, the Reserve Bank issued draft guidelines on credit default swaps (CDS) to put in place a regulatory framework for such transactions. However, in view of the current complexities in the international credit markets, it was decided to keep in abeyance the issuance of the final guidelines on the introduction of credit derivatives in India. The CFSA is of the view that these guidelines may be finalised after suitable modifications, drawing lessons from recent global financial market events.

Guidelines on CDS may be finalised after drawing lessons from the recent global market events.

While noting the impact of securitised loan assets and credit derivatives in perpetuating the turmoil triggered by sub-prime lending by global financial institutions and banks, the Panel on Financial Stability Assessment and Stress Testing noted that the reasons for the sub-prime crisis not impacting India very adversely are the following:

i) Limited exposure of Indian banks that have global operations to sub-prime assets.

ii) Lack of an 'originate to distribute' model in India as markets for securitised assets are still limited.

iii) Virtual non-existence of a credit derivatives market.

iv) The guidelines of the Reserve Bank on securitisation do not permit immediate profit recognition or re-computation of credit enhancements.

While the sub-prime crisis points towards adopting a cautious approach, the Panel noted that given the capital-raising constraints facing Indian banks, the credit risk transfer mechanism needs to gain ground. In this context, the Panel felt that the credit derivatives market can be developed by allowing more participants and products. The participants should be well regulated and should follow transparent practices. Entry norms for participants should be clearly stipulated. FIMMDA could play a pro-active role by ensuring stable market infrastructure for proper settlement of trade.

To mitigate the risks associated with credit risk transfer (CRT) instruments, regulation and supervision should be geared not only to credit, market and operational risks but also to liquidity risk. Liquidity risks emanating from off-balance sheet items and the inter-linkages of CRT instruments with other markets need to be recognised. Enhanced regulatory co-operation is needed for effective regulation of both entities and activities. Appropriate valuation and provisioning norms as also proper recognition of prevailing governance and legal impediments are required and should be factored into the pricing of the product. A specific capital charge could be stipulated beyond a threshold limit. CRT instruments could be exchange traded to enhance transparency.

Adequate disclosure norms need to be in place. In respect of credit default swap (CDS) exposures both year-end and peak positions should be disclosed. All CDS transactions should be mandatorily reported in a common reporting platform, like NDS. There should be greater mandated disclosure of banking book assets and a rating-wise classification of outstanding protection sold.

The CFSA acknowledges that credit derivatives are an essential hedging tool for banks and facilitate a broad distribution of risk outside the banking system, which probably improves the overall efficiency and resilience of financial markets. It makes it easier to mitigate concentrations of credit risk and helps diversify credit risk. Despite the benefits to financial resilience, the changes in the credit markets have also provoked some concerns and unease, particularly in view of the recent financial turmoil. While generally in agreement with the Panel's views, the CFSA feels that the following measures could be considered before going in for regulatory incentives for the development of credit derivatives markets.

Enhanced regulatory co-operation is needed for effective regulation of credit risk instruments.

i) Capacity Building: In past there was a period of relatively favourable financial conditions, and the prospects for future stability will depend in part on the degree of care and conservatism that market participants bring today to judgements about risk management. Financial

institutions need to develop capacity to measure their exposure to risk in a less benign market and economic environment.

ii) Senior Management Oversight: Senior management and boards of directors need to understand the limitations and uncertainty that pervade the tools used to assess these risks, to try to better understand the potential scale of losses the firm may face, and to carefully examine how well risk exposures reflect the overall risk appetite of the firm and the size of the capital and liquidity cushion maintained in relation to those exposures.

iii) Infrastructure: Market participants need to keep up with the pace of change in the market through continued investment in both risk management and the processing infrastructure.

iv) Settlement: Credit derivatives should be recorded and settled through a clearing corporation.

v) Rating Agencies: One of the prime causes for the sub prime crisis was the role of the rating agencies in respect of bundled instruments, particularly in relation to credit derivatives. There is a need for objective rating within an appropriate regulatory framework for rating agencies.

Hence, there is a need to follow a gradualist approach by sequencing the reforms and putting in place additional safeguards before the introduction of credit derivatives. The CFSA feels that the Reserve Bank could consider the views of the Panel from this angle.

There is a need to follow a gradualist approach by sequencing the reforms and putting in place additional safeguards before the introduction of credit derivatives.

**4.6.3 Summary**

The corporate bond market has not taken off due to factors such as lack of buying interest, low transparency and absence of pricing of spreads against the benchmark. Given the increased access to off-shore markets for Indian corporates, the supply from corporates is also inadequate. Further, a sizable market is captured by the large issuance of credit risk-free government securities and the issuance of low-risk subordinated debts at attractive interest rates by banks as part of their Tier II capital. The absence of DVP is another obstacle in market development. The tax deducted at source (TDS) system for corporate bonds acts as an impediment to the development of secondary market activities. A series of measures, both regulatory and legislative, need to be embarked upon for the development of the corporate bond market. Some of the important measures are:

i) Making corporate bonds repoable in a phased manner.

ii) Consolidating all trades reported in different reporting platforms and disseminating the same to enhance transparency.

iii) Considering expediting the development of hedging instruments, like credit default swaps.

iv) Further simplifying the debt issuance process and starting a phased movement towards anonymous order matching trading systems.

v) Introducing DVP in corporate bonds.

vi) Rationalising stamp duty.

vii) Abolishing TDS.

viii) Introducing reforms in the pension and insurance sectors.

ix) Having timely and efficient bankruptcy procedures in place.

The issue of opening up the corporate debt market to foreign investors has to be approached with caution. As long as there is a significant difference between Indian and international inflation rates, and hence interest rates, without corresponding expectations related to the evolving exchange rate, opening the Indian debt market to foreign investment can raise issues of financial stability.

While the sub-prime crisis points towards following a somewhat cautious approach, given the capital-raising constraints facing Indian banks the credit risk transfer mechanism needs to gain ground. The participants should be well regulated and should follow transparent practices. Entry norms for participants should be clearly stipulated. FIMMDA could play a pro-active role by ensuring stable market infrastructure for proper settlement of trades.

Liquidity risks emanating from off-balance sheet items and the inter-linkages of CRT instruments with other markets need to be recognised. CRT instruments could be exchange traded to enhance transparency. The approach to the development of the securitised market should be gradual and calibrated. Transparency at every stage of the securitisation chain needs to be enhanced. Regulators can consider stipulating specific capital charges beyond a certain threshold.

Financial institutions need to develop capacity to measure their exposure to risk in a less benign market and economic environment. Senior management and board members need to understand the limitations and uncertainty that pervade the tools used to assess these risks, better understand the potential scale of losses the firm may face, and to carefully examine how well risk exposures reflect the overall risk appetite of the firm and the size of the capital and liquidity cushion maintained in relation to those exposures. Market participants need to keep up with the pace of change in the market through continued investment in both risk management and in

the processing infrastructure. The settlement of credit derivatives should be through a clearing corporation. There is a need for objective rating within an appropriate regulatory framework for rating agencies.

## 4.7 Concluding Remarks

Financial markets in India have evidenced significant development since the financial sector reforms initiated in the 1990s. The development of these markets has been done in a calibrated, sequenced manner and in step with those in other markets in the real economy. The emphasis has been on strengthening price discovery, easing restrictions on flows or transactions, lowering transaction costs, and enhancing liquidity. Benefiting from a series of policy initiatives over time, greater domestic market integration has also been witnessed.

The equity, government securities, foreign exchange and money markets along with their corresponding derivatives segments have developed into reasonably deep and liquid markets and there has been significant increase in domestic market integration over the years. However, the credit derivative market is yet to take off in any significant manner. As regards corporate bonds, though the primary market has seen an increase in issuance, the secondary market has not developed commensurately.

The equity market has witnessed wide-spread development in infrastructure and its functioning is comparable to international standards. It has seen significant increase in growth and diversity in composition in the last two decades. Certain areas, however, could be further developed. According SRO status (subject to appropriate safeguards) to certain trade and industry associations to enhance regulatory efficiency, further improvements in infrastructure and risk management systems, more focused monitoring of market intermediaries, streamlining of issuance procedures and the enhancement of knowledge standards of the current and potential market participants through national investor education and financial literacy are some of the major steps that could be considered.

With the economy moving towards fuller capital account convertibility in a calibrated manner, focused regulation and monitoring of the foreign exchange market assumes added importance. In this context, there is a need to strengthen infrastructure, transparency and disclosure, and product range in the foreign exchange derivative markets. Strengthening the trading infrastructure, market conduct, transparency of OTC derivatives in the foreign exchange market, accounting and disclosures in line with

international practices, including disclosures by non-bank corporates, needs to be done on a priority basis. The recent introduction of currency futures is a step in this regard.

The government securities market has witnessed significant transformation in its various dimensions, *viz.,* market-based price discovery, widening of the investor base, introduction of new instruments, establishment of primary dealers and electronic trading and settlement infrastructure. This is the outcome of persistent and high-quality reforms in developing the government securities market. There are still areas where further development needs to be undertaken. Increased transparency and disclosures, gradual scaling down of mandated instruments and development of newer instruments are some major areas which could be considered. Regulatory incentives to increase the size of the trading book could be considered as a measure to further develop the government securities market.

The money market is an important channel for monetary policy transmission and has generally conformed to being a liquid market. The gradual shift towards a collateralised inter-bank market, phasing out of non-bank participants from the call money market, policy directions towards reductions in statutory reserve requirements, the introduction of new instruments such as CBLO, implementation of RTGS, significant transformation of monetary operations framework towards market-based arrangements and facilitating trading through NDS-CALL are some of the factors that have contributed to the development of a relatively vibrant and liquid money market. However, the inability of market participants to take a medium-to long-term perspective on interest rates and liquidity, coupled with the absence of a credible long-term benchmark, is a major hurdle for further market development and needs to be addressed.

The development of the corporate bond market, which could be a source of long-term finance for corporates, has been strongly recommended as a key reform area by the Advisory Panel on Financial Stability and Stress Testing as well as the peer reviewers. The development of this market currently suffers from a lack of buying interest, absence of pricing of spreads against the benchmark and a flat yield curve. It requires regulatory and legislative reforms for its development.

The unbridled proliferation of complex credit derivatives and excessive risk transfer by adoption of the originate-to-distribute model is recognised as one of the root causes of the current financial crisis. The recent credit turmoil has also underscored the importance of liquidity risk arising from off-balance sheet commitments, implicit or explicit, of the credit intermediaries. In the wake of the turmoil in global financial markets, the Financial Stability Forum (FSF) brought out a report in April, 2008 identifying the underlying causes and weaknesses in international financial markets. The Report contains, *inter alia*, proposals of the FSF for implementation by end-2008 regarding strengthening

prudential oversight of capital, liquidity and risk management, enhancing transparency and valuation, changing the role and uses of credit ratings, strengthening the authorities' responsiveness to risk and implementing robust arrangements to deal with stress in the financial system. The Reserve Bank had put in place regulatory guidelines that were aligned with global best practices, while tailoring them to meet country-specific requirements and covering many of these aspects; in regard to others, actions are being initiated. In many cases, actions have to be considered as work in progress. While the development of markets for credit derivatives and asset securitisation products could play a critical role in furthering economic growth, this requires to be pursued in a gradual manner by sequencing reforms and putting in place appropriate safeguards before introducing such products.

Stability in financial markets augurs well for financial soundness. In fact, markets are the major conduits for transmission of impulses which could either enhance or impact the stability of the financial system as a whole. While financial market reforms need to be accorded appropriate priority, given the risks arising from cross-sectoral spillover of financial markets to other segments of the financial spectrum, there is a need to be careful and nuanced in approaching financial market reforms in the interests of financial stability.

## Chapter V

# Financial Infrastructure

## 5.1 Introduction

A robust and secure financial infrastructure is the cornerstone of financial stability and development. The CFSA, taking into account the Indian institutional and market environment, decided to cover aspects relating to stability and development in the following areas as part of the financial infrastructure:

i) Regulatory structure covering aspects relating to supervision and regulation of banking, insurance and securities markets as also other intermediaries.

ii) Liquidity infrastructure, including an assessment of the efficacy of instruments for management of monetary and foreign exchange operations.

iii) Legal infrastructure for the financial system, including legal and institutional environment for effective bankruptcy procedures.

iv) Governance infrastructure, including aspects related to corporate governance.

v) Accounting and Auditing infrastructure and their convergence to international standards.

vi) Payment and securities settlement infrastructure.

vii) Business continuity management.

viii) The existence of safety nets in the system with reference to deposit insurance.

ix) Financial system integrity – aspects relating to anti-money laundering and combating financing of terrorism (AML/CFT).

## 5.2 Regulatory Structure

In India, different segments of the financial system are regulated by different regulators. The Reserve Bank, the Securities and Exchange Board of

India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) are the three major regulatory ones, and the Pension Funds Regulatory and Development Authority (PFRDA) would be another regulator once the PFRDA Bill 2005 is passed by the Parliament. While regulatory jurisdictions between these four are demarcated, there are some areas of overlap and gaps requiring close co-operation and co-ordination. The Ministry of Finance and the Ministry of Corporate Affairs, as well as State Governments, have a somewhat segmented, but at times overlapping regulatory jurisdiction over the functioning of the system. The Central Government, in particular, has some over-arching powers over the financial system and policies as a whole, guiding, *inter alia*, regulatory policies.

The Indian financial system has evolved over time and so is the case with the regulatory structure. The Reserve Bank was set up in 1935 under an Act of 1934 'to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'. The main functions of the Reserve Bank as laid down in the statutes are: issue of currency, banker and fiscal agent to the Government, including the function of debt management, and banker to other banks.

Unlike most other central banks, the Reserve Bank was specifically entrusted with an important promotional role since its inception to finance agricultural operations and marketing of crops. The Reserve Bank, as a central bank, also performs the function of maintaining the external value of the rupee. The areas of regulatory and supervisory jurisdictions of the Reserve Bank have expanded over time, through a series of amendments to the RBI Act as also other legislations like the BR Act, FERA/FEMA, Government Securities Act, and Payment and Settlement Systems Act. While there was no fundamental change in its core objectives as stated in the Preamble to the Act, its role and functions have continuously evolved with time. The Reserve Bank also performed a developmental role by creating within it institutions like the Industrial Development Bank of India, Unit Trust of India, Agricultural Refinance and Development Corporation, Industrial Finance Corporation of India, and National Housing Bank, which were later hived off as independent institutions.

The areas of regulatory and supervisory jurisdictions of the Reserve Bank have expanded over time.

The Reserve Bank has been entrusted with the regulation and supervision of India's banking system under the provisions of the BR Act. The regulation over foreign exchange was acquired through the Foreign Exchange Regulation Act, 1973 that was replaced with the Foreign Exchange

Management Act, 2000. With the passage of the Payments and Settlement Systems Act in Parliament, the Reserve Bank has the legislative authority to be the regulator and supervisor of the payment and settlement systems. Consequent upon amendments to the RBI Act from time to time, the regulatory powers of the Reserve Bank also cover non-banking financial companies (NBFCs) and select all-India financial institutions. The Government Securities Act, enacted in 2006, has replaced the erstwhile Public Debt Act and has provisions relating to the issue of new loans and payment of interest. It contains provisions relating to the transfer of government securities, the nomination of holders of government securities, and the issue of duplicate securities and new securities. The Act empowers the Reserve Bank to frame regulations as to the terms and conditions for the issue of government securities, the form in which they can be issued and the fee to be charged for the maintenance of the SGL and CSGL accounts and bond ledger accounts, the form and manner in which government securities can be transferred, and the manner in which the Reserve Bank determines the title to government securities. The Reserve Bank is also empowered under the Act to impose penalties if any person contravenes any of the provisions of the Act. The amendments to the RBI Act in 2006 brought clarity with regard to the Reserve Bank's regulation over money, foreign exchange, gold-related securities, government securities and related derivatives products[91].

The regulatory powers over other segments of the financial system such as capital markets and the insurance sector were originally vested with the Central Government through various ministries and departments. Consequent to the expansion of the capital market, the need for an independent capital market regulator was felt and SEBI emerged as the regulator of the capital market and related intermediaries, including stock exchanges, depositories, credit rating agencies, foreign institutional investors (FIIs) and collective investment schemes like mutual funds under the SEBI Act, 1992 as modified from time to time. Similarly, with the opening up of the insurance sector dismantling the earlier Government monopoly, the IRDA was set up to regulate and supervise insurers, both life and non-life, and re-insurers under the IRDA Act, 1999.

The PFRDA is a more recent entrant, with the announcement of the new pension scheme, which is a defined contribution pension system as against the previous defined benefit scheme which followed a 'pay-as-you-go' approach. It will become fully functional as and when the PFRDA Bill, 2005 is passed by Parliament.

The existence of several regulators and the multiplicity of their roles and objectives can potentially introduce conflicts of interest between regulation and supervision. First, many regulatory agencies have multiple roles which may be in conflict with one another. Second, potential conflicts arise because regulatory agencies also own some of the financial institutions in which they are responsible for regulatory and supervisory oversight. Over

[91] Chapter III D, Section 45 W of the RBI Act.

Presence of multiple regulators is perhaps consistent with the transitional phase of financial development.

time, various term lending industrial finance institutions were established with varying degrees of Reserve Bank involvement, which has been continuously involved in setting up or supporting these institutions, including equity contributions and extension of lines of credit. Though the general practice has been to hive the institutions off as they attained financial self-sufficiency to address potential conflicts of interest, the Reserve Bank still owns NHB, NABARD and DICGC (all of which it also regulates).

A third set of issues identified by the Panel arise from the fact that several regulatory/supervisory agencies are also mandated with a market development role, and some function, at the same time, as development banks, with refinancing windows. The Reserve Bank itself undertakes various developmental functions in respect of institutions, markets and infrastructure within its regulatory jurisdiction. Similarly, SIDBI regulates state financial corporations (SFCs), while also functioning as a development bank that provides refinancing to commercial banks and SFCs; NHB has a refinancing window for housing finance companies (HFCs), which it regulates and is also mandated with a market development role. Similarly, NABARD plays a developmental role in respect of rural financial institutions. In order to effectively demarcate these regulatory and developmental roles, several of these institutions have created a separate quasi-independent body for dedicated focus on financial supervision. A flowchart of the regulatory structure of Indian Financial system is given in Chart 5.1.

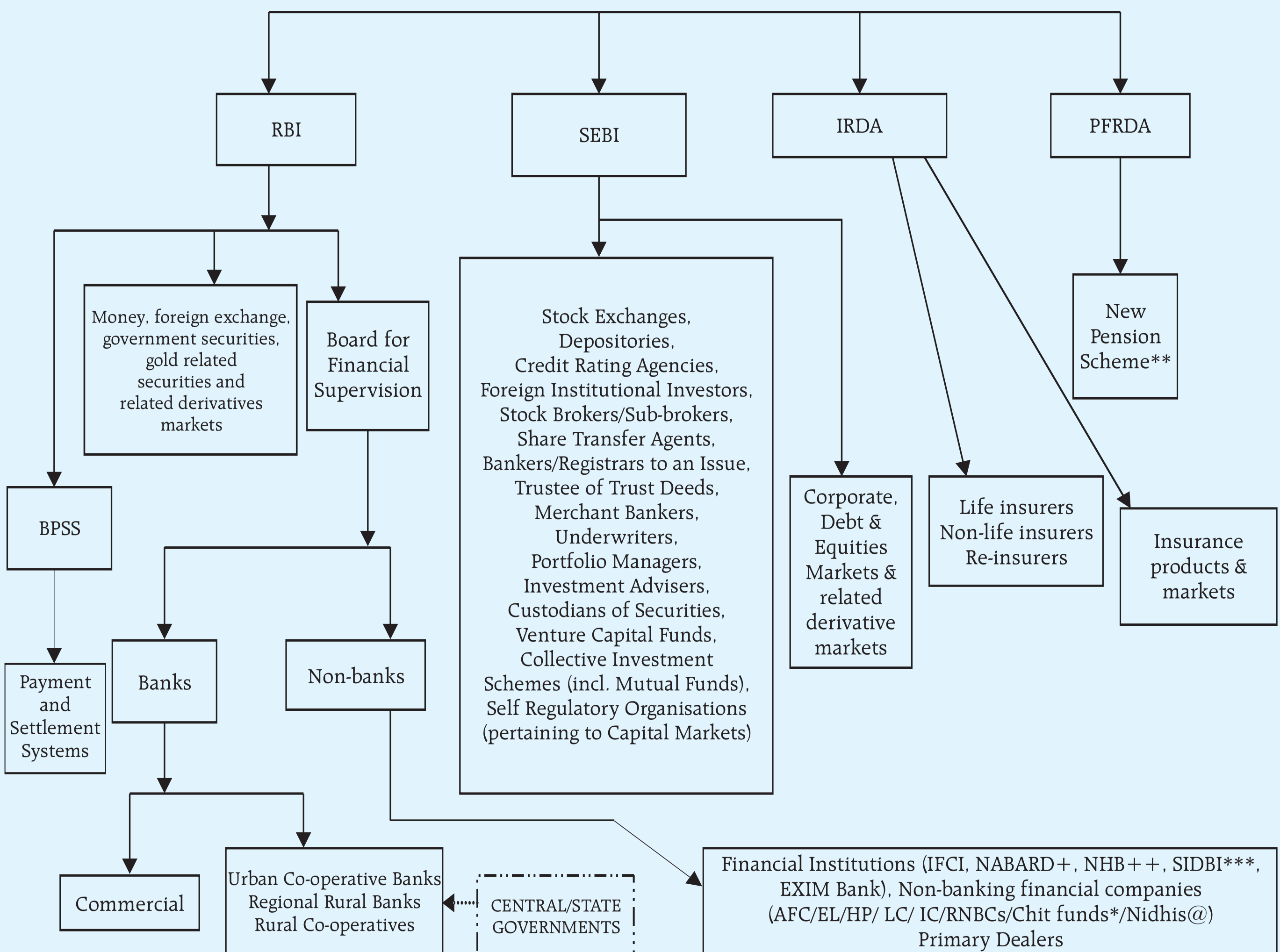
The CFSA is of the view that presence of multiple regulators is perhaps consistent with the transitional phase of financial development. The real issue lies in co-ordination of the financial policies which has often been found lacking even in a super-regulator environment. This has been mentioned by Mr Sundararajan, the peer reviewer of the Advisory Panel Report on Financial Stability Assessment and Stress Testing. It would, therefore, be more in order for the regulators to focus on co-ordination, collaboration, and information-sharing among themselves rather than on institutional integration of agencies or separation of functions. The Panels on Financial Regulation and Supervision and Stability Assessment and Stress Testing felt that strengthening of HLCCFM as a co-ordinating body in this regard, particularly in identifying and resolving cross-jurisdictional issues, is desirable.

The real issue lies in the co-ordination of the financial policies, which have often been found to be lacking even in a super-regulator environment.

### 5.2.1 Principles-based vs. Rules-based Regulation

With regard to regulation, most countries follow a rules-based approach, wherein regulators attempt to prescribe in great detail exactly what the regulated entities can and cannot do. Critics of rules-based regulation are,

## Chart 5.1: Regulatory Structure of the Indian Financial System – Institutions and Markets




* deposit-taking activities only; controlled by State Governments
*** SIDBI regulates State Finance Corporations
@ interest rate ceilings fixed by RBI; controlled by Ministry of Corporate Affairs

* * PFRDA Bill 2005 is awaiting Parliamentary approval
\+ NABARD has supervisory responsibilities over rural credit institutions –RRBs and co-operatives

however, of the view that the plethora of rules that regulated entities in the system are expected to follow tends to inhibit risk-taking and innovation.

An alternative proposed in recent times is principles-based regulation wherein the broad principles of regulation are articulated, avoiding the codifying of details of allowable products, markets or business plans. In a principles-based system, how a principle would be applied remains at the discretion of the regulator (often kept deliberately vague). While the rules-based approach is often likened to a 'check-list' approach, with objective verification of observed compliance standards, the principles-based approach places an enormous burden on the supervisory staff who need to be adequately equipped to make judgements regarding the business plans of the financial firm. In a principles-based system, how a principle will be applied remains at the discretion of the regulator, reducing the transparency of rules, which is essential for a competitive market; on the other hand, in a rules-based system the regulated entity is aware of the regulations and what is required to enter a field and compete.

Moving away from these two approaches, the US Treasury in March 2008 issued a Blueprint for Financial Regulatory Reform which envisages objectives-based regulation.[92] This model would have three regulators: a regulator focused on market stability across the entire financial sector, a regulator focused on safety and soundness of those institutions supported by a federal guarantee, and a regulator focused on protecting consumers and investors.

India follows a model of regulation which is primarily rules-based. Over a period of time, India has built up a large repository of subordinate laws through a codification of detailed rules and regulations by specialised regulators, which detail the permissible features of financial products and services and also the functioning of the financial markets.

There has recently been an ongoing debate on the virtues of these two approaches to regulation. In this context, the Panel on Financial Regulation and Supervision has expressed its reservations towards changing the Indian approach to principles-based regulation, given the state of our development, markets, expertise and skills, and the level of compliance at the ground level. The Panel feels that there should be a mix of approaches in adopting an appropriate regulatory model for India with elements of both principles-based and rules-based regulation. A regulatory regime could be adopted in which a principles-based approach is applied initially only for the development of new and innovative products, thus creating a conducive atmosphere for product

[92] Refer Advisory Panel on Financial Stability Assessment and Stress Testing-Chapter 5-Box 5.1.

development without curtailing innovation, and continue otherwise with a rules-based approach. An alternative approach could be to apply a principles-based approach only in respect of advanced market segments in the country. But, in view of the variety of segments and the differing levels of their development and regulation, defining a threshold level for this purpose would be a formidable task at this stage. It needs to be kept in mind that adopting either of the approaches could result in a fair degree of ambiguity in the overall regulatory environment, at least in the initial stages of their introduction.

The CFSA believes that rules-based and principles-based approaches to financial regulations are complementary and not mutually exclusive.

The Panel, therefore, concluded that before any large-scale migration to an alternative regulatory regime, the relevant issues need to be examined in detail. Significant amendments to existing legislations governing the regulatory framework of the financial system would also be needed.

The Panel on Financial Regulation and Supervision and Stability Assessment and Stress Testing was of the view that a clear demarcation between 'principles-based regulation' and 'rules-based regulation' is difficult and both cannot be avoided in practice. There is, however, a need to ensure that rules have clear principles, which clearly state the regulatory objectives and also the possible benchmarks against which regulatory performance will be assessed. The rules should be drafted so that they are easy to understand and easy to implement or enforce. The basic principles that should be followed are that, at the outset, the basic principles and objectives should be clearly enunciated and the regulations should be built around these principles. This would be helpful to the regulator and the regulated entity to refer back to the principles when in doubt.

A clear demarcation between 'principles-based regulation' and 'rules-based regulation' is difficult.

The CFSA carefully considered the two forms of regulation prevalent across countries on the basis of the assessment and recommendations of two Advisory Panels. The conflict between principles- and rules-based regulations arises from a perceived notion of 'false dichotomy'. The CFSA believes that rules-based and principles-based approaches to financial regulations are complementary and not mutually exclusive**.** A similar view has been expressed by the peer reviewer, Mr. Sundararajan, of the Advisory Panel Report on Financial Stability Assessment and Stress Testing. In the Basel II accord, for example, Pillar I guidelines are more in the form of rules, while Pillar II and III guidelines are more in the form of principles. The CFSA also notes that FSA, UK, one of the few countries which applies principles-based regulation, has a set of as many as 60 manuals or sourcebooks, each containing detailed rules. Hence, to view principles-based regulation as simpler to understand and implement does not appear to be correct.

The right approach would be to group the existing rules according to a few principles.

The Advisory Panel on Stability and Stress Testing has stated that the rules should ideally be derived from a set of principles which clearly state the regulatory objectives and also the possible benchmarks against which regulatory performance will be assessed. The CFSA seconds this view and recommends that the right approach would be to group the existing rules according to a few broad set of principles and to check whether they satisfy these principles. In the case of deviations, a view could be taken as to whether the concerned rules need to be continued with or could be dispensed with.

This would also obviate the rules/regulations degenerating into ad-hocism. Recognising the varied stages of development of players across markets and institutions, separate sets of rules would be required for different regulated entities within the broad parameters earmarked in the principles.

**5.2.2 Supervision of Financial Conglomerates (FCs)[93]**

In the face of the accelerating pace of consolidation in the financial industry and the intensification of links between various financial markets, a number of cross-sector organisational forms combining banks, insurance companies and investment firms have been created. Regulation and monitoring of the financial operations of such large complex financial organisations [also called Financial Conglomerates (FCs)], have posed significant problems as they often create new prudential risks while exacerbating existing ones. From a regulatory perspective, the growth of these FCs has led to appreciation about some of the issues that arise from a segmental approach to supervision in addressing the risks associated with them and a need to address these issues so that conglomerate-wide supervision can be undertaken. In the absence of a unified or super-regulator, the onus of regulating such entities perforce becomes the joint responsibility of regulatory agencies. This calls for strengthening arrangements for inter-regulatory corporation. There has been an increase in the number of FCs in India in recent years. For the purpose of supervision, 12 institutions that have a significant presence in banking, insurance, NBFC, housing finance and capital markets have already been identified as FCs.

While most financial supervisors have recognised that financial conglomerates require and deserve some form of specialised supervision, the regulatory approaches to this supervision differ greatly in their responses to some of the underlying problems of conglomerate regulation (Box 5.1). In its papers on 'Supervision of Financial Conglomerates' (February 1999), the Joint Forum[94] on Financial Conglomerates, formed under the aegis of the Basel

Financial conglomerates require and deserve some form of specialised supervision.

[93] Reference - Evolving Trends in the Supervision of Financial Conglomerates: A Comparative Investigation of Responses to the Challenges of Cross-Sectoral Supervision in the United States, European Union, and United Kingdom - Cameron Half - April 30, 2002.

[94] The Joint Forum owes its origins to the Tripartite Group which was formed in early 1993 to address a range of issues relating to the supervision of financial conglomerates. The Tripartite Group was created at the initiative of the Basel Committee and composed of bank, securities and insurance supervisors, acting in a personal capacity but drawing on their experience of supervising different types of financial institutions. The Tripartite Group recognised the trend towards cross-sector financial conglomerates and issued a Report in July 1995 raising issues of concern in the supervision of financial conglomerates. The purpose of this Report, published as a discussion document, was to identify challenges that financial conglomerates pose for supervisors and to consider ways in which these problems may be overcome. To carry this work forward, a formal group was put together, being the basis for the above Joint Forum.

**Box 5.1: How Countries Supervise Financial Conglomerates**

The increasing tendency towards conglomeration has led to an appreciation of the limitations of the segmental approach to supervision since such supervisory approaches reflect only the traditional business activities and perspectives within each segment not incorporating the increasing cross-segmental risk transfers and investments.

The model of the single integrated supervisory authority - with competence over banking, investment and insurance activities - spread from the Scandinavian area and got a fillip with the establishment of FSA by the UK in 1998. Most countries have adopted the model of unified or integrated supervision by either establishing a single supervisor for their entire financial sector or by centralizing in one agency the powers to supervise at least two of their main financial intermediaries, such as banking and insurance, banking and securities firms, or securities firms and insurance.

In several other countries, steps have been taken to strengthen co-operation between the existing supervisory bodies. In the Netherlands, a Council of Financial Supervisors was established in 1999 to supplement the existing forms of co-operation between the three supervisory authorities. In France, the co-operation between the different authorities has been strengthened. Australia has adopted an 'objectives-based' supervisory architecture with a distinction between prudential supervision, market integrity and systemic stability. Some other regulatory regimes have adopted an exclusive supervisory framework for identified conglomerates, the most prominent among them being the USA and the European Union. The European Central Bank (December 2006) has adopted a cluster analysis for identifying financial conglomerates for financial system stability assessment.

**Reference:** Report of the Working Group on Monitoring of Systemically Important Financial Intermediaries (Financial Conglomerates) – May 2004.

Committee on Banking Supervision (Basel Committee), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to take forward the work of the Tripartite Group, had set out principles for group-wide capital adequacy, fit and proper requirements, supervisory information-sharing and co-ordination. The most comprehensive component of the Joint Forum's recommendations is capital provision, and particularly the emphasis on double/multiple-gearing and leveraging. However, the inclusion of fit and proper criteria, information sharing and co-ordination principles demonstrates a recognition that the risks of conglomerates cannot be addressed by capital standards alone, and that effective supervision must be customised to account for the particular corporate and operational structure of a particular conglomerate to address issues in relation to intra-group contagion over leveraging and camouflaging of financial risk.

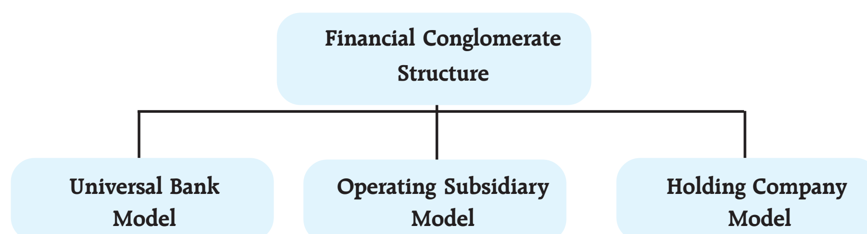
Currently, a monitoring and oversight framework in India is in place for FCs that complements the regular supervision of individual entities by the respective regulators, *viz.*, the Reserve Bank, SEBI, IRDA and the system of Consolidated Financial Statements/Consolidated Prudential Reporting applicable to banks. The FC monitoring framework rests on three components: (i) off-site surveillance through receipt of quarterly FC returns; (ii) reporting relevant concerns on financial conglomerates to the standing Technical Committee having members from the Government, the Reserve

Conglomerate supervision in India is in the early stages of evolution and implementation.

Bank, SEBI, IRDA and PFRDA, and (iii) holding of periodic discussions by the principal regulator with the top management of the conglomerate in association with other regulators to address outstanding issues/supervisory concerns.

The CFSA observes that conglomerate supervision in India is still in its early stages of evolution and implementation, both on a domestic as well as on a cross-border basis. It notes that some legal impediments also prevent effective information-sharing and joint inspections by the regulators even within the existing rudimentary framework.

The three distinct structural forms of financial conglomerates are:

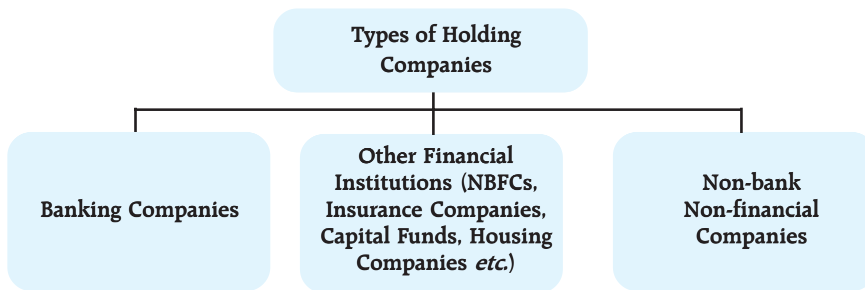



In the universal bank model, all financial operations are conducted within a single corporate entity. The second model is the parent-subsidiary or operating subsidiary model, in which operations are conducted as subsidiaries of another financial institution, usually (but not necessarily) a bank. Finally, in a holding company model, activities are conducted in legally distinct entities, each with separate management and capital, but all owned by a single financial or sometimes (unregulated) non-financial institution. The most common structure of financial conglomerates in India is based on the operating subsidiary model. There are no universal banks in India. Also, given the lack of clarity in the existing statutes relating to the regulation and supervision of financial holding companies, the holding company structure as prevalent in the US for financial conglomerates is not currently prevalent.

Legal impediments prevent effective information-sharing and joint inspection by the regulator.

In this context, the Panel on Financial Stability Assessment and Stress Testing notes that the exclusion of the holding company structure in financial conglomerates exposes investors, depositors and the parent company to risks, strains the parent company's ability to fund its own core business, and could restrict the growth of the subsidiary business. The Panel felt that the legal and regulatory gaps would need to be expeditiously addressed.

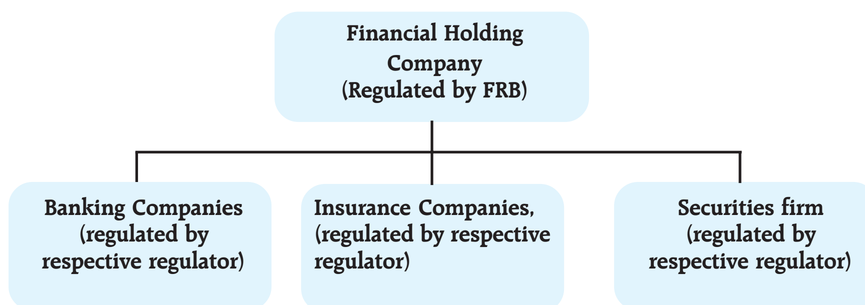
Holding companies in India could potentially be of three types:




Each holding company could have under its ambit financial institutions like banks, insurance, mutual funds, asset management companies, NBFCs, or HFCs. The banking functions of a bank holding company would come under the regulatory ambit of the Reserve Bank of India. The non-bank financial institutions could be under the regulatory ambit of any of the financial regulators like the Reserve Bank, SEBI or IRDA, depending on the principal business of the holding company.

At present, there is no legislation specifically permitting regulation of FCs and holding companies in India. It needs to be examined whether, given the nature of financial conglomerates in India, an amendment to the existing legislation would be sufficient or whether there is need for a new legislation for supervision of financial conglomerates. The CFSA is of the view that legislation of a new Act, similar to the 1999 Financial Services Modernisation Act or the Gramm-Leach-Bliley (GLB) Act of the USA (which authorises the Federal Reserve Board to have supervisory oversight over financial holding companies) is required to empower the regulator to have regulatory jurisdiction over the holding company. As in the case of the GLB, the structure of holding company supervision can be 'silo plus' regulation. This term describes the supervisory structure in which supervision of each business line, usually described as 'functional' supervision, is combined with an additional level of supervision at the holding company level. This system seeks to maintain the strengths and expertise of the existing regulatory system while responding to changes in the risk profile of an institution that engages in activities that may cut across multiple traditional functional classifications.

**Holding Company Model in the USA**




Legislation of a new Act is required to empower the regulator to have jurisdiction over the holding company.

The proposed legislation requires to be more comprehensive than the GLB in as much as it should empower the central bank, in this case the

The onus of maintaining financial stability lies with the Reserve Bank.

Reserve Bank, to have regulatory reach over holding companies which do not even have any group company which is within the functional regulatory domain of the Reserve Bank[95]. Financial stability being the overriding objective of a central bank which is the only entity having LoLR powers in times of extraordinary market conditions and crises, the central bank, according to the CFSA, could be armoured with sufficient supervisory powers and also monitoring functions in respect of FCs. In the current financial scenario, it is becoming increasingly clear that the onus of maintaining financial stability lies with the central bank as was evident from the bail-out of Bear Sterns by FRB of New York. Bear Sterns – an investment bank – is not within the regulatory domain of FRB, New York.

Based on the above analysis, the CFSA is of the view that the following recommendations should be considered:

(i) In the case of an FC where the apex institution is a bank holding company, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank.

(ii) In the case of an FC with a non-bank holding company (financial or non-financial) having a bank within its structure, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank.

(iii) In the case of an FC with a non-bank financial holding company whose activity is within the regulatory jurisdiction of the Reserve Bank, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank irrespective of whether there is a bank within its structure.

(iv) In the case of an FC with a non-financial holding company, the holding company should be explicitly within the regulatory outreach of the Reserve Bank, to the extent that the Reserve Bank is empowered to obtain information as relevant from time to time, even if there does not exist a bank within the FC structure.

Reserve Bank should act as umbrella supervisor for holding companies.

(v) As in the case of the FRB's role in the US as umbrella supervisor, the interactive relationship between the Reserve Bank and the other regulators of the insurance, securities, commodities, and housing needs to be streamlined.

[95] The requirement to have a bank in the financial group is a pre-requisite for qualifying as a financial holding company (FHC) in the USA.

In this context, the CFSA believes that allowing 'intermediate' holding companies may not be feasible until an appropriate regulatory structure for such an entity is in place.

Allowing 'intermediate' holding companies may not be feasible until an appropriate regulatory structure for such an entity is in place.

In addition to the 'silo plus' FC supervisory system, each FC could report to a 'Lead Regulator' which would exercise regulatory and supervisory authority in relation to the entity's primary function. The Advisory Panel on Financial Regulation and Supervision is of the view that supervision of such entities, with businesses in more than one sector of the economy that cut across different regulatory domains, could be conducted collaboratively by the regulators, with the lead regulator co-ordinating the supervision across various jurisdictions, subject to the parameters of co-ordination being well-defined and ground rules being specified. This would be applicable for the operating subsidiary model of FC structure. Entities under the FC that function in a regulatory vacuum, *i.e.*, which do not fall within the regulatory/ supervisory ambit of any single regulator, should be brought under the regulatory reach of the lead regulator who will assess risks emanating from contagion, governance structure, fund flows, and capital requirements. There should be a clear mandate through a Memorandum of Understanding between the FC and the lead regulator in this regard. It would also be the responsibility of the lead regulator to co-ordinate with the Reserve Bank in case the FC is of a holding company structure.

In this connection, the CFSA endorses the Reserve Bank's initiative to insert Clause 29 A in the BR Act, which would give it powers to inspect the books of accounts and other records of all entities that are subsidiaries/ associates of a bank, irrespective of whether the subsidiary /associate is under any other regulator. It also notes that an approach paper on regulatory and supervisory framework for monitoring of financial conglomerates is being finalised. As recommended by the Panel on Financial Regulation and Supervision a similar change in law, as suggested by the Advisory Panel on Financial Regulation and Supervision, may also be necessary for other lead regulators.

The CFSA endorses the Reserve Bank's initiative to insert Clause 29 A in the BR Act.

**5.2.21 Certain Related Issues**

It is often argued that the existence of a unified regulator is a necessary precondition for effective supervision of FCs. In this context, the CFSA feels that a unified regulatory environment is not without its pitfalls. The recent bail-out of Northern Rock Bank in the UK is a case in point. In spite of the existence of a single unified regulator and explicit tripartite memoranda of understanding among the FSA, Bank of England and the Treasury, there was significant confusion in handling the crisis faced by Northern Rock. In contrast, the USA, with its multiple regulators, was able to handle the Bear Stearns issue in a more efficient manner through timely and effective co-ordination between the Federal Reserve and the US Treasury. The CFSA believes that it is necessary to strengthen inter-regulatory co-operation and co-ordination between the Government and regulators in the interests of financial stability.

It is necessary to strengthen inter-regulatory co-operation and co-ordination.

Yet another issue in the context of supervision of FCs is whether the supervisory and regulatory functions should be separate from the role of the monetary authority and lender of last resort (LoLR). The argument for separation is premised on the basic conflict of interest leading to the monetary authority exercising undue forbearance towards supervised entities. The sub-prime turmoil has brought into focus the difficulties that central banks face in being effective LoLR without sufficient knowledge about the current or prospective value of the institution's balance sheet or its liquidity/solvency position. Consequently, there is a growing re-examination regarding the separation of the monetary and regulatory functions of central banks.

In the Indian context, while LoLR as also regulatory and supervisory functions are conducted by the Reserve Bank, an arm's length relationship between the Board for Financial Supervision and monetary function already exists. Any further separation of the two functions could lead to loss of synergies between the regulator, monetary authority and LoLR from the stability perspective as these roles often become blurred during crisis situations, as in the case of the recent sub-prime turmoil, or periods of significant illiquidity. In the Indian context, the Reserve Bank being the regulator, monetary authority, and the LoLR is well placed to meet such challenges through effective information-sharing between its supervisory and monetary policy wings and arrangements with other regulators. This issue has been duly addressed by the Panel on Financial Regulation and Supervision and was also highlighted by Mr. Eric Rosengren in his peer review. He stated that the mechanisms for fulfilling the LoLR responsibilities have important implications for regulatory structure. In particular, the LoLR must have the ability and necessary data to assess the solvency risk and liquidity risk of institutions that may use the facility. Apart from ensuring proper utilisation of the facility, this risk assessment capacity should also help to reduce the incidence of events that cause an aggregate shortage of liquidity and thus call for interventions from the LoLR.

The lender of last resort must have the ability and necessary data to assess the solvency risk and liquidity risk of institutions.

### 5.2.3 Self-Regulatory Organisations

Self-Regulatory Organisations (SROs) are entities authorised by statute or an agency to exercise some delegated jurisdiction over a certain aspect of the industry or markets. They are non-government organisations which have a statutory responsibility to regulate their own members through the adoption and enforcement of rules of conduct for fair, ethical and efficient

practices. SROs could complement the primary regulators in achieving the objectives of regulations. They also permit quicker, more flexible responses to financial conditions. Particularly in the context of regulation of financial markets, the IOSCO Principles recognise that SROs need to be encouraged for efficient market development. The IMF Code for Transparency in Financial Policies asserts that SROs should be subject to the same standards of transparency as the regulatory agencies.

*Current Status in India - Issues*

In 2004, SEBI framed full-fledged guidelines on the registration, duties and responsibilities of an SRO in the form of SEBI (SRO) Regulations, 2004. As per these regulations, an SRO is defined as an organisation of intermediaries that represents a particular segment of the securities market and that is duly recognised by SEBI under these regulations. At present, there are no formally recognised SROs under the above regulations. But, historically, the functions of SROs in respect of regulations and inspection are being performed by stock exchanges, like the BSE and the NSE, by virtue of their defined functions. The Advisory Panel on Financial Stability Assessment and Stress Testing is of the view that, with the demutualisation of stock exchanges, there is a need for SROs as front-line regulators of market intermediaries.

In the insurance sector, the Life Insurance Council and the General Insurance Council envisaged by the Insurance Act, 1938 were revived in February 2000, and at present perform the role of SROs in a limited manner by setting up market conduct standards for insurers. A broker licensed by the IRDA is necessarily required to be a member of the Insurance Brokers Association of India which functions as an SRO with a Disciplinary Committee in place. The IRDA has established the Indian Institute of Insurance Surveyors and Loss Assessors to promote self-regulation and professionalism among surveyors.

The Reserve Bank is yet to evolve guidelines for the recognition and approval of SROs in the areas of money, government securities and foreign exchange markets, though the Foreign Exchange Dealers' Association (FEDAI) has perforce been performing delegated regulatory functions ever since its inception in 1958.

Though official initiatives regarding SROs are still lacking, the strong development of financial markets has necessitated the evolution of several industry/trade associations, assuming self-regulatory roles and thus having the potential of being converted to full-fledged SROs in their respective fields. Such institutions which perform some functions akin to SROs, include:

There are various trade associations having the potential of being converted to SROs.

*Equities/Corporate Bond Market*

- Association of Mutual Funds in India (AMFI)
- Association of Merchant Bankers of India (AMBI)
- Association of NSE Members of India (ANMI)

*Money, Foreign Exchange and Government Securities Markets*

- Fixed Income Money Market and Derivatives Association of India (FIMMDA)
- Financial Planning Standards Board of India (FPSBI)
- Primary Dealers Association of India (PDAI)
- Foreign Exchange Dealers Association of India (FEDAI)

*Banking*

- Indian Banks' Association (IBA)

Each of the above organisations is engaged in playing a share of their role in furthering the interests of an orderly marketplace. None of the respective bodies in the equity/corporate bond market have so far sought registration with SEBI under its 2004 regulations. FIMMDA is reported to have sought Reserve Bank approval to be recognised as an SRO in the money market, but a decision has not been taken. FEDAI has been undertaking regulatory functions, as delegated by the Reserve Bank, and to that extent it is a *de facto* SRO and hence the Advisory Panel on Transparency Standards assessed its status for transparency in Financial Policies. The Advisory Panel on Financial Regulation and Supervision, however, concluded that FEDAI does not fulfill certain requirements under IOSCO Principles to be treated as a full-fledged SRO in the foreign exchange market.

**5.2.31 Advisory Panel Recommendations**

The Advisory Panel on Financial Regulation and Supervision recommended that Associations like the Association of NSE Members of India, Association of Mutual Funds in India, Association of Merchant Bankers of India and Financial Planning Standards Board of India should be accorded SRO status and gradually brought under the regulatory ambit of SEBI, by defining their jurisdiction and delegating them appropriate powers. The Panel also recognised the effective role that could be played by SROs in regulating investment advisers and research analysts through prescription of licensing and registration requirements, apposite credentials and appropriate returns.

SROs can play effective role in regulation of investment advisors and research analysts.

FIMMDA and PDAI have been contributing to the development of new benchmarks and products in the money market and related derivatives segments, in addition to providing training and development support to market participants and primary dealers. FIMMDA has been assisting the Reserve Bank in formulating uniform accounting practices for repo /ready

forward contracts and master repo agreements and is also involved in the valuation of Central Government securities. The Advisory Panel on Financial Stability Assessment and Stress Testing had, therefore, observed that though neither of the two is formally recognised as an SRO, the Reserve Bank has been consulting them as part of its developmental and regulatory functions. Particularly in the case of FIMMDA, where members of PDAI form the major part, the Panel recommended giving it full-fledged SRO status to streamline the money market and related derivatives regulation. On a similar note, the Advisory Panel on Financial Regulation and Supervision was of the view that in order to impart stability to the government securities market by augmenting regulatory resources and at the same time permitting quicker and more flexible responses to market conditions, self-regulatory status could be considered for FIMMDA.

FEDAI has been undertaking several delegated regulatory functions since August 1958. But it is still in the nature of an industry-level body that represents authorised dealers (banks and other players who are authorised to deal in foreign exchange). Its major activities include framing rules to govern the conduct of inter-bank foreign exchange business among banks *vis-à-vis* the public and liaising with the Reserve Bank for reforms and development of the foreign exchange market. The Advisory Panel on Financial Regulation and Supervision has, however, observed that in terms of the requirements of IOSCO Principles, FEDAI does not fulfill the basic tenet of an SRO. This is because, as required by the IOSCO Principles in the case of SROs, it does not establish any eligibility criteria for individuals or firms to participate in activities in foreign exchange markets. It has also not been brought under the regulatory ambit of the primary regulator, *viz.*, the Reserve Bank. The Panel therefore, recommended further empowerment to FEDAI for its transition into a full-fledged SRO.

While being strongly supportive of supervising SROs for market development and regulation, the Panels had also brought out certain limitations in the functioning of SROs and the need to put some safeguards in place. In this context, the Panel on Financial Regulation and Supervision noted that the existence of strong and effective self-regulatory organisations (SROs) is an important prerequisite for moving towards principles-based regulation. The Panel recognised the potential conflicts of interest that need to be addressed. It suggested that either the designated SROs suspend their functions as trade/industry associations or change their governance structure to ensure effective bifurcation of operations. Against the backdrop of evolution of regulation, the SROs' role lies in ensuring that in the course of such contextualisation and evolution, the spirit behind the principles remains protected.

Potential conflicts of interest needs to be addressed.

Similarly, ineffective market discipline has been identified by the International Association of Insurance Supervisors (IAIS) as a potential threat to emerging markets, and needs to be tackled to enable the healthy growth of the insurance industry. As envisaged by the Panel on Financial Regulation and

Supervision, over time much of the developmental role currently played by the IRDA has the potential to be passed on to SROs.

**5.2.32 CFSA Stance**

While the CFSA is generally in agreement with the visible advantages of SROs and their importance in lessening the burden of the regulator and allowing it to focus on policy issues, it is also of the view that formal oversight of SROs is a necessity. This is because complex governance issues could arise in managing the conflicts of interest between their commercial objectives and their development/regulatory role, which would require strong oversight by the primary regulator. Also, SROs should not be seen as lobbying institutions for their members with the regulator; this assumes greater relevance in the context of the demutualisation of stock exchanges in India. The issues relating to governance arise from factors such as the composition of their board and the independence of directors, the independence and functioning of key committees of the board, the transparency of the SROs' decision-making process, and the diligence and competence required of board and committee members. Basically, the issue to be addressed and resolved is the conflict of interest within a trade body/association, combined with it being a regulator.

The CFSA, therefore, feels that the regulator should ensure an arm's length relationship between the SRO and the associated trade bodies and examine its corporate governance policies before according SRO status. In this context, the importance of SROs in the US securities market, specifically the relationship between the National Association of Securities Dealers (NASD) and the National Association of Securities Dealers Automated Quotation System (NASDAQ) is a case in point. NASD, which regulates close to 5,100 member firms, created NASDAQ as its subsidiary in 1971. However, in view of the conflict of interest in its roles as the owner, operator and regulator of a market and in order to distinguish regulation from operations and focus solely on its oversight functions, it completely severed its financial ownership over NASDAQ. In this context, the Advisory Panel on Financial Regulation and Supervision undertook a study of cross-country practices (Box 5.2).

Regulator should ensure an arms length relationship between SROs and associated trade bodies.

A considerable body of literature suggests that there could be substantial benefits from self-regulation if combined with adequate safeguards, as SROs would ensure the observance of ethical standards which go beyond government regulations and would offer considerable depth and expertise in market operations and practices, besides reducing the overall cost

## Box 5.2: Cross-country Practices Regarding SROs in Securities Markets

**USA**

SROs are an important ingredient in the regulation of the US Securities markets. The Securities Exchange Commission (SEC) delegates significant regulatory authority to SROs that are securities industry member funded and operated organisations. The mandate of these SROs is to oversee the member firms participating in these markets and to enforce compliance by the members and their employees with the laws and regulations. These SROs are subject to oversight by the SEC. In July 2007, NASD and the New York Stock Exchange (NYSE), merged to form the Financial Industry Regulatory Authority (FINRA), which is the largest non-governmental regulator for all securities firms doing business in the United States.

**Australia**

As a market licensee under the Corporations Act, Australian Stock Exchange (ASX) has the power to establish rules and standards for listed entities and market participants, monitor compliance with those rules and standards and impose disciplinary actions. In July 2006, ASX established a separate subsidiary for its market supervisory operations called ASX Markets Supervision. This subsidiary carries out all of the ASX's supervisory operations, has its own Board and is headed by a Chief Supervision Officer who reports to the Board of the subsidiary and the Board of ASX. ASIC and ASX Supervisory Review provide oversight to ASX Markets Supervision.

**Hong Kong**

The Hong Kong Exchange and Clearing (HKEx) is the holding company that owns and operates stock and futures exchanges in Hong Kong and their related clearing houses. Since the Stock Exchange of Hong Kong demutualised in 2000, the Securities and Futures Commission, which is the regulator, has assumed many of the responsibilities for the stock exchange. Specifically, the SFC is the front-line regulator for listed companies and in that capacity carries out market surveillance, investigates and punishes all breaches of law and is statutory regulator for listed companies' disclosure. The SFC is also responsible for member regulation and carries out routine inspections, monitors compliance with business conduct and financial resource rules and investigates and punishes all breaches of applicable rules and regulations.

**United Kingdom**

The London Stock Exchange (LSE)'s listing activities were transferred to the Financial Services Authority in 2001, in part because the Government was concerned that competition between exchanges continued to increase and that it would not be appropriate for the LSE, which had been designated as the UK Listing Authority, to act as gatekeeper for all the exchanges. As a result and due to subsequent changes, the FSA regulates all securities trading in the UK and is also the listing authority for the UK. The LSE continues to maintain a rulebook for trading firms and, as the frontline monitor of market behaviour, conducts surveillance of trading activities.

**Japan**

The Tokyo Stock Exchange (TSE) has statutory authority as an SRO and in that capacity is responsible for maintaining a transparent, equitable and reliable market. To fulfil that objective, TSE establishes rules and regulations for member firms and listed companies, continuously monitors member firms and listed companies in order to ensure that they comply with TSE's rules and regulations and carries out enforcement actions when violations are found to have occurred. TSE also establishes rules for the listing of securities and conducts surveillance activities.

**Source :** Advisory Panel on Financial Regulation and Supervision.

of regulation. They may also be able to respond more quickly and flexibly than the regulator to changing market conditions. With self-regulation in place, not only could market misconduct be reduced significantly but the pace of development could also increase since industry and regulator would align their efforts towards a common goal. Finally, a self-regulation culture could help increase investor confidence and keep the momentum of market development at a steady pace. In the Indian context, however, the CFSA feels that the issue of granting SRO status by the regulators needs to be carefully considered and the possible further benefits from according this status to the organisations needs to be debated.

The CFSA further recognises that granting SRO status to any institution necessitates the fulfillment of certain preconditions. It will require introduction of transparent policies by the regulators for defining, identifying, and approving SRO status to institutions which are already performing implicitly or more explicitly self-regulatory functions in the financial sector. This could be the first step to pave the way for evolving more generalised policies towards self-regulation, with some experience gained in the functioning of these organisations. The regulatory initiatives in this regard are inadequate and there are considerable ambiguities about the status of certain organisations such as FEDAI in the foreign exchange market and stock exchanges in the securities market. Furthermore, though organisations like AMBI, AMFI, and FIMMDA were conceived to eventually evolve into SROs in their respective areas, none of them has been recognised as an SRO. Even SEBI, after the formulation of guidelines in 2004, has not accorded SRO status to any organisation. The CFSA observes that institutions such as ANMI, AMBI, AMFI, and FPSB did not assume the role of SROs due to the stringent guidelines, as revealed through the interaction SEBI had with them. SEBI is modifying the SRO regulations in consultation with international agencies.

**5.2.4 Independence of Regulatory and Supervisory Authority**

Establishing adequate arrangements for autonomy of regulatory and supervisory authorities is crucial to reducing the likelihood of government interference in the supervisory process. While many central banks have become legally more independent in the past 20 years – with demonstrably positive results in terms of increased monetary stability – the debate on regulatory independence is at the same stage that the debate on central bank independence was two decades ago.

There are considerable ambiguities about the status of FEDAI and stock exchanges.

Nonetheless, independence for financial regulatory agencies is important for financial stability for many of the same reasons that central

bank independence matters. An independent regulator can ensure that the rules of the regulatory game are applied consistently and objectively over time. The crises that erupted during the 1990s in a number of countries where regulatory and supervisory agencies were not independent strongly support the case for independence (Box 5.3).

Independence has different dimensions like regulatory, supervisory, institutional and budgetary independence. Regulatory independence refers to the ability of the agency to have an appropriate degree of autonomy in setting rules and regulations for the sectors under its supervision within the confines of law. Supervisory independence can be increased through provision of legal protection to supervisors, introduction of rules-based sanctions and interventions, appropriate salary levels and clarity of banking law regarding layers of decisions and time allowed for appeal by institutions sanctioned by supervisors (the supervisor should have autonomy in relation to licensing and exit procedures). Institutional independence relates to terms of appointment and dismissal of senior supervisory personnel, the agency's governance structure and its openness and transparency in decision making. Budgetary independence refers to the role of the executive/legislature in relation to the funding requirement of the agency[96].

**Box 5.3 : Perils of Lack of Independence–Some International Experiences**

Before the Asian crisis began in 1997, ***Korea's*** specialised banks and non-bank financial institutions were under the authority of the Ministry of Finance and Economy. The ministry's supervision of non-banks was generally recognised as weak, encouraging regulatory arbitrage and excessive risk taking. As in many other Asian crisis countries, politically-motivated forbearance was widespread. The most glaring examples of political interference in financial sector supervision were the Government's decisions to intervene in certain banks or to provide them with government funds for recapitalisation.

In ***Japan***, the lack of independence of the financial supervision function within the Ministry of Finance is also widely believed to have contributed to financial sector weaknesses. Although there was probably little direct political pressure on the Ministry of Finance to exercise forbearance, the system lacked transparency and was known for widespread implicit government guarantees of banking sector liabilities. Following a decline in the ministry's reputation as a supervisor in the late 1990s, the Japanese Government created a new, integrated Financial Supervisory Agency, which was more independent and transparent than its predecessor had been. However, the agency, which reports to the Prime Minister's office rather than to the Finance Ministry, has achieved disappointing results to date.

Ineffective regulation, weak and dispersed supervision, and political interference in ***Venezuela*** were among the main factors in the weakening of banks in the run-up to the 1994 banking crisis. Former central bank president, Ruth de Krivoy, has emphasised that one of the main lessons of this crisis was that there was a need for more independence for financial sector regulators and supervisors and political support for their work.

**Source :** IMF – Finance & Development – December 2002.

Regulatory independence refers to the ability of the agency to have an appropriate degree of autonomy in setting rules and regulations.

[96] Reference: Financial Regulators Need Independence – Udaibir. S. Das, Mark Quintyn and Michael. W. Taylor – IMF – Finance & Development, December 2002.

SEBI is a statutory body established under the SEBI Act, 1992 and its powers and functions are enshrined in the SEBI Act, Securities Contract (Regulation) Act, 1956, Depositories Act, 1996 and Companies Act, 1956. As per its Preamble, its basic functions are to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto.

Though it is empowered to frame regulations without the approval of the Central Government and operate and exercise its powers given under the above Acts without external political and commercial interference, the Panel was of the view that there are certain provisions like Section 6[97] of the SEBI Act, 1992 which restrict its independence. The Panel on Financial Regulation and Supervision noted that Section 5(2) gives the Central Government the right to terminate the services of the Chairman or Member at any time by giving a notice of three months, which appears to be in apparent conflict with the tenor of the other sections in the SEBI Act and could have implications for the independence of SEBI. Consequently, the Panel felt that Section 5(2) can be removed from the SEBI Act.

The Panel further noted that other provisions in the SEBI Act may impinge upon its independence. Section 16 of the SEBI Act empowers the Central Government to issue directions on questions of policy and the decision of the Central Government would be final, irrespective of whether or not the issue is one of policy. Further, under Section 17, the Government has been given the power to supersede the Board, *inter alia*, on the grounds of persistent default in complying with any directions issued by the Central Government.

In this context, the Government points out that vide Sec 16 of the SEBI Act the Central Government has powers to issue directions 'on questions of policy' and it needs to be given in writing. However, on whether a question is policy or not, the decision of the Government is final. This is *pari-materia* with similar powers of the Central Government *vis-à-vis* other Statutory Regulatory Agencies (SRAs). Sec 17 (power of the Central Government to supersede the board) or Sec 18 (powers to call for returns and Reports), are accountability arrangements within a constitutionally valid regulatory architecture and cannot be interpreted as dilution of regulatory autonomy.

[97] Section 6 of the Act states that a member can be removed in circumstances referred to therein after being afforded a reasonable opportunity of being heard. Further, as per Section 17 of the Act, in cases of grave emergencies or where SEBI is unable to discharge its functions or in the public interest can the Board of SEBI be superseded by the Central Government.

Checks and balances and accountability arrangements have to be part of a sustainable regulatory model as the regulator, with whatever autonomy, cannot stand in a vacuum. However, it also needs to be noted that the Ministry of Finance has never exercised these powers *vis-à-vis* SRAs.

The Ministry of Finance has never exercised the powers of removal of head/superseding of boards of Statutory Regulatory Agencies (SRAs).

The Insurance Regulatory Development Authority (IRDA) is an independent agency which reports to Parliament through the Ministry of Finance. The Chairperson of IRDA is appointed by the Appointments Committee of the Cabinet headed by the Prime Minister. The Central Government reserves the right to remove any member, including the Chairman, under specified conditions.

As regards the Reserve Bank, the Panel noted that it enjoys autonomy in respect of framing regulations and issuing directions to banks and also legal protection for its actions. It was observed that while the directors nominated to the Board could be removed only on incurring the disqualifications mentioned in Section 10 of the RBI Act, for the Governor and Deputy Governors there were no explicit provisions detailing the situations in which they could be removed. In fact, Section 11 of the Act provides that the Central Government may remove the Governor or Deputy Governor from office without specifying any reasons for the same. Further, in terms of Section 30 of the RBI Act, the Government also has the power to supersede the Central Board of the Reserve Bank in specific circumstances.

The Panel noted that the multiplicity of tasks[98] that the Reserve Bank undertakes could lead to conflict in some situations. Hence, the case for total institutional independence needed to be viewed in this context. It was felt that while the Central Government, *de jure*, is empowered to remove the Governor without assigning any reason, since such power has seldom been exercised, the Reserve Bank is perceived as one of the most independent and autonomous bodies in the Indian financial sector. With such a convention already in place, and the checks and balances of a strong and vibrant democratic system, the Government would run a huge reputational risk if it decided to remove the Governor without sufficient cause. Considering the Reserve Bank's success as a regulator amidst its diverse activities, and also the fact that by convention the Reserve Bank's independence is fairly well established, the Panel felt that, at present, there was no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/Deputy Governor could be removed. Such changes were not likely to add or make any material difference to the autonomy that the Reserve Bank already enjoys as a regulator.

The Government would run a huge reputational risk if it decided to remove the Reserve Bank Governor without sufficient cause.

**5.2.41 Financial Independence**

The Reserve Bank was established on April 1, 1935 under the RBI Act as a private shareholders' bank and thereafter nationalised in 1949. It is financed

[98] Regulator and supervisor of commercial banks, monetary authority of the country, sovereign debt management, and foreign exchange reserve management.

by its own budget and has not required any financial support from the Central Government and in fact transfers its surplus profit to the Central Government. With a view to maintaining the strength of the Reserve Bank's finances, the transfer of balance of profits, after necessary provisions, to the Central Government was rationalised as part of the reform process in 1997. The present arrangement is governed by the objective of reaching a stipulated level of reserves in the Reserve Bank's balance sheet over a period of time – though the time-frame to reach the level is extended by mutual consent to accommodate immediate fiscal compulsions. Under these circumstances, the Reserve Bank may be considered to enjoy a very high degree of financial independence.

SEBI is empowered to levy fees and other charges for performance of its functions. It is not dependent on the Government or any authority for its funds. During its initial days, the Government provided interest-free loans which are being repaid by SEBI from its fund. The provision for fees and penalties under the SEBI Act are considered adequate at present to meet the resource needs of SEBI.

IRDA is an autonomous body formed by the Insurance Regulatory Development Authority Act, 1999. With respect to financial independence, the Government has raised the issue of transfer of IRDA's funds to the central exchequer (Public Accounts of India). While the request has not yet been acceded to and is under examination, any action in this regard would be detrimental to and raise serious concerns relating to the supervisor's stature as an autonomous regulator.

Regulators provide a public good at a cost. The Panel on FRS underscores the need to maintain their financial independence and the CFSA concurs with the views of the Panel.

**5.2.5 Regulatory Co-operation**

Regulators provide a public good, and their financial independence is critical to their functioning.

Concurring with the Panel on Financial Stability Assessment and Stress Testing, Mr. Andrew Sheng, peer reviewer, points out that the existence of multiple regulators is perhaps inevitable in this transitional phase of financial development. However, multiple and conflicting roles of the regulators may lead to an increase in the scope of regulatory arbitrage which could be exploited by financial conglomerates, in particular. Some of the imperatives in regulation and supervision are the existence of an effective and transparent regulatory co-ordination mechanism that aims at streamlining issues on capital adequacy, like double/multiple gearing of capital, accounting

standards, appropriate disclosure requirements, particularly in relation to overall risk management, and financial policy transparency.

The Panel on Transparency Standards observes that, at present, co-operation and information sharing between the Reserve Bank and other regulatory agencies is handled by a formal standing committee. The Government, by an executive order, has set-up a High Level Co-ordination Committee on Financial Markets (HLCCFM) consisting of the Governor, the Reserve Bank, Chairman, SEBI, Chairman, IRDA, Chairman, PFRDA and the Finance Secretary, Government of India. The Committee has further constituted three technical committees under the jurisdiction of the Reserve Bank, SEBI and IRDA to report on matters which have a bearing on the financial and capital markets. In order to make this arrangement effective, it is imperative that meetings of the apex committee, the HLCCFM, and the technical committees are also held on a regular basis and that the exchange of information is adequate and timely. The absence of such co-ordination pose risks to systemic stability. Free, frank, regular and institutionalised exchange of information between all the regulators has become an important imperative for the Indian financial system.

The Panel has recommended that this arrangement needs to be institutionalised and brought under a formal and transparent arrangement. With regard to co-operation with overseas regulators, the SEBI has been entering into Memorandum of Understanding (MoU) for regulatory co-operation, mutual assistance and sharing of information with overseas securities markets regulatory authorities. IRDA does not have any such formal arrangement, although there is sharing of information of regulatory/ supervisory concern. In respect of international agencies, a need-based information-sharing mechanism is in place in the Reserve Bank. The Panel has recommended that this mechanism can be publicly disclosed.

The Panels on Financial Stability Assessment and Stress Testing and Financial Regulation and Supervision have suggested various measures to strengthen the HLCCFM. The major recommendations are:

(i) HLCCFM should be supported by a formal institutional mechanism enabling it to give directions to regulatory authorities on issues cutting across regulatory domains. Its functions should be clearly delineated and placed in the public domain.

(ii) Increase cross-board membership among the regulators to expose members from other agencies to critical issues.

(iii) Draw up and test MoUs for their ability to ensure co-ordination, with a formal memo to the HLCCFM to resolve issues in the case of conflicts.

(iv) Better information-sharing among the regulators by addressing the legal impediments in this regard.

Both Mr. Andrew Sheng and Mr. Sundararajan underscored the need for formalising the HLCCFM with appropriate MoUs.

Formalisation of the powers of the HLCCFM would amount to erosion of the regulators' autonomy.

The CFSA acknowledged that because the regulatory regime has undergone certain fundamental changes in India, such as from being a government-dominated financial system to a market-oriented one, new regulators like those for pension, insurance and the capital market have been created and the focus on regulation/supervision has also changed from micro to macro and from on-site to more off-site. For greater efficiency, the issues of regulatory co-ordination have become increasingly crucial. The CFSA notes that in the context of putting into the public domain the functions of the HLCCFM, the arrangements, as they stand today, have been put out by the regulators through policy statements, web-sites and publications; developments pertaining to their functioning have also been put in the public domain. Hence, the arrangements have been transparently and formally disseminated.

The CFSA further observed that institutionalisation and formalisation of the co-ordination arrangements in a stringent fashion might be counter-productive as they may take away the freedom and flexibility necessary for the formulation and implementation of financial sector policies. With regard to the Panel's suggestion that the HLCCFM should be enabled to give directions to regulatory authorities, the CFSA observes that this is not consistent with the independence of regulatory authorities. Moreover, the Secretariat of the HLCCFM is lodged in the Government and Government officials are formal members. Hence, formalisation of the powers of the HLCCFM would amount to erosion of the regulators' autonomy. A more appropriate solution is a 'consensus' approach by the members of the HLCCFM as is currently practised. The CFSA, therefore, views the current arrangements as adequate because they have maintained systemic stability through inter-regulatory co-ordination and no further stringent formalisation of arrangements would be necessary. The arrangements, however, need to be continuously monitored and the effectiveness of the HLCCFM strengthened through greater exchange of information in a need-based and timely manner may be explored and put in place, when necessary.

Internationally, success of regulatory co-operation is based on a consensus approach, without rigid and formal approaches.

Mr. V. Sundararajan, peer reviewer, stresses that it is more important to focus on co-ordination, collaboration and information sharing among different regulators than on institutional integration of agencies or separation of functions. The CFSA is broadly in concurrence with the view. It observes that, internationally, success of regulatory co-operation is based on a consensus approach, without rigid and formal approaches, as evidenced from the swift and co-ordinated actions of the regulators in the face of the sub-prime crisis (Box 5.4). In the case of the Northern Rock crisis, the three

## Box 5.4: Regulatory Co-ordination in a Crisis

**(1) Tripartite arrangement for financial crisis in the UK**

A tripartite approach to crisis management is available in the UK. The central bank, regulator and Government (in the form of the Treasury) have distinct roles to play and these roles need to be carried out co-operatively. The framework for this co-operation is provided by the tripartite Memorandum of Understanding, first drawn up in 1997 when responsibility for banking supervision moved from the Bank of England to the newly-established FSA. The MoU was revised in March 2006[99].

The FSA is responsible for the authorisation and prudential supervision of financial firms; the supervision of financial markets and clearing/settlement systems; carrying out various actions in response to problem cases; and for regulatory policy in these areas. The Treasury is responsible for the overall institutional structure of financial regulation, and for informing and accounting to Parliament any serious problems in the financial system. The principal forum for co-ordinating and agreeing action between the three authorities is the Standing Committee on Financial Stability. This is chaired by the Treasury and comprises senior representatives of the three authorities. It meets monthly at Deputy level, and meetings can also be called at other times by any of the participating authorities if they feel that there is an issue which needs to be addressed urgently.

In exceptional circumstances, for instance where a support operation is being considered, the Standing Committee would meet at Principal level [the Chancellor, the Governor and the Chairman (or senior alternates)]. The tripartite authorities have established a detailed working-level co-ordination procedure which would underpin these Standing Committee arrangements. These processes are designed to ensure that the authorities' response is orderly, that they gather and share relevant information quickly and that they act in a co-ordinated way. They have been developed in the light of experience from two simulation exercises, one in June 2004 and the other in October 2005; and they will be regularly reviewed in the light of experience and periodic testing. The over-arching guiding principle for the UK response to a financial crisis is that support operations or other exceptional interventions should only be undertaken 'in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy.'

The ultimate responsibility for authorising support operations rests with the Chancellor. He would do so with advice (for which he would be accountable) from both the Bank of England and the FSA. The MoU requires *each* authority to assess the seriousness of the crisis and its potential implications, and to provide *separate* assessments to the Treasury together with their views on the options available to the Chancellor.

**(2) Actions by the Federal Reserve Bank of New York in Response to Liquidity Pressures in Financial Markets[100]**

The actions taken by the Federal Reserve in response to the situation that arose at Bear Stearns was shaped in roughly four stages:

[99] Managing a bank-specific crisis: A UK perspective: Ian Bond, Head of Financial Crisis Management Division, Bank of England.

[100] Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Washington, D.C., Timothy F Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York.

*(1) The decision on the morning of March 14, 2008 (Friday) to extend a non-recourse loan through the discount window to JPMorgan Chase so that JPMorgan Chase could in turn lend that money to Bear Stearns*

Rumours started doing rounds in the days leading up to March 13 that European financial institutions had stopped doing fixed-income trades with Bear. This led to a number of U.S.-based fixed-income and stock traders, hedge funds, investment banks and money market funds halting business with Bear Stearns.

Bear Stearns renewed conversations that began earlier that day with JPMorgan Chase, which is Bear's clearing bank for its repo arrangements, to explore a range of possible financing options. The New York Fed dispatched a team of examiners to Bear Stearns to look at its books to get a better handle on what could be done. After careful deliberations that Fed Reserve had with colleagues at the Board of Governors and the Treasury, it was agreed that the New York Fed would extend an overnight non-recourse loan through the discount window to JPMorgan Chase, so that JPMorgan Chase could then 'on-lend' that money to Bear Stearns. Meanwhile Bear continued to explore options with other financial institutions that might enable it to avoid bankruptcy; and policymakers continued to try to contain the risk to financial markets in the event no private sector solution proved possible.

During March 14, Bear was downgraded by the credit rating agencies, and the flight of customer business from Bear accelerated. This set in motion a chain of decisions across the financial system as market participants prepared for the possibility that Bear would not be open for business once Asian markets opened on Sunday night. This highlighted the urgency of working towards a solution over the weekend, one that would definitively address the prospect of default by Bear.

Bear approached several major financial institutions, beginning on March 13 to explore the possibility of a merger. Ultimately, only JPMorgan Chase was willing to consider an offer of a binding commitment to acquire the firm and to stand behind Bear's substantial short-term obligations. As JPMorgan Chase and other institutions conducted due diligence, the Fed continued to examine ways to contain the effects of a default by Bear. Following the announcement on March 12 of the Term Securities Lending Facility, which allowed primary dealers to pledge a wider range of collateral in order to borrow Treasury securities, the Fed was able to work quickly on a companion facility that would transmit liquidity to parts of the market where it could be most powerful.

*(2) The decision on March 16, 2008 (Sunday) by JPMorgan Chase and Bear Stearns for JPMorgan Chase to acquire Bear Stearns and guarantee certain of its liabilities, along with an agreement in principle that the Federal Reserve Bank of New York would provide certain financing in the context of that acquisition*

This is what led the Board of Governors of the Federal Reserve System to approve the establishment of the Primary Dealer Credit Facility on March 16. Under Section

13(3) of the Federal Reserve Act, the Board of Governors is empowered to authorise a Federal Reserve Bank like the New York Fed to lend to a corporation, such as an investment bank, in extraordinary circumstances under which there is evidence that the corporation cannot 'secure adequate credit accommodations from other banking institutions.'

On Sunday morning, executives at JPMorgan Chase informed the Fed that they had become significantly more concerned about the scale of the risk that Bear and its many affiliates had assumed. They were also concerned about the ability of JPMorgan Chase to absorb some of Bear's trading portfolio, particularly given the uncertainty ahead about the ultimate scale of losses facing the financial system.

The Fed did, however, have the ability to lend against collateral, as in the back-to-back non-recourse arrangement that carried Bear into the weekend. After extensive discussion that New York Fed Chairman Bernanke and Secretary Paulson had with Fed officials, the New York Fed and JPMorgan Chase reached an agreement in principle that the New York Fed would assist with non-recourse financing. Using Section 13(3) of the Federal Reserve Act, the New York Fed agreed in principle to lend US dollar 30 billion to JPMorgan Chase and to secure the lending with a pledge of Bear Stearns assets valued by Bear on March 14 at approximately US dollar 30 billion. This step made it possible for JPMorgan to agree to acquire Bear and to step in immediately to guarantee all of Bear's short-term obligations.

On the evening of Sunday the 16th, the Fed sent a letter to James Dimon, CEO of JPMorgan Chase, to memorialise the fact that a preliminary agreement has been entered into that the New York Fed would assist the acquisition with US dollar 30 billion in financing, with the understanding that the parties would continue working during the week towards a formal contract. The Fed also provided regulatory approvals, including under Section 23A, to assist with the merger and a transitional period for phasing in the assets under their capital rules.

*(3) Launching of the Primary Dealer Credit Facility*

The announcement of the agreement between Bear Stearns and JPMorgan Chase and the announcement of the Primary Dealer Credit Facility were finalised just before Asian markets opened on Sunday night, and the announcement of these actions helped avert the damage that would have accompanied default.

On Monday morning, March 17, the US dollar 13 billion back-to-back non-recourse loan through JPMorgan Chase to Bear was repaid to the Fed, with weekend interest of nearly US dollar 4 million. The Primary Dealer Credit Facility was made available to the market.

Discussions were also continuing regarding the details of the Fed's financial arrangement with JPMorgan Chase. Fed legal teams engaged in the meticulous work of finalising the legal structure of the lending arrangement that had been agreed to in principle, including defining the precise pool of collateral and related hedges that would secure the US dollar 30 billion loan. At the same time, several infirmities became evident in the agreement between JPMorgan and Bear during the week of March 17 that needed to be cured.

Negotiations between the two sets of counterparties proceeded almost immediately between the New York Fed and JPMorgan Chase on the one hand, and between JPMorgan Chase and Bear Stearns on the other. The New York Fed and JPMorgan discussed the details for the secured financing. Bear Stearns and JPMorgan

continued to negotiate changes to the merger agreement that would tighten the guarantee and provide the necessary certainty that the merger would be consummated. All the parties shared an overriding common interest: to move towards a successful merger and avoid the situation in which they found themselves on March 14.

*(4) The events of the following week, culminating in the March 24, 2008 announcement of a revised merger agreement and guaranty terms between JPMorgan Chase and Bear, and the finalising of the terms and structure of the associated loan from the Federal Reserve Bank of New York*

The extended Easter weekend saw intense sets of bilateral negotiations among the three parties. The deal, finally struck in the early morning hours on March 24, held benefits for all parties. That deal included a new, more precise guaranty from JPMorgan, which lifted the cloud of default risk that had been hanging over the transaction. Bear stockholders were to receive a higher share price. In addition to fixing the guaranty, JPMorgan gained assurance that its merger with Bear would take place and the New York Fed obtained significant downside protection on the loan and a tighter guaranty on its exposure. The new Fed financing facility will be in place for a maximum of 10 years, though it could be repaid earlier, at the discretion of the Fed. This is an important feature: the assets that are being pledged as collateral can be managed on a long-term basis so as to minimise the risks to the market and the risk of loss. They can be held or disposed of at any time over the next decade.

In keeping with the traditional role of lender of last resort, the extensions of credit to Bear Stearns that the Fed made to facilitate the merger were secured by collateral. The US dollar 29 billion loan will be extended only if and when JPMorgan Chase and Bear merge. The Fed will be protected from loss by three different risk mitigants: first, a substantial pool of professionally-managed collateral that, as of March 14, was valued at US dollar 30 billion; second, the agreement on the part of JPMorgan Chase to absorb the first US dollar 1 billion of any loss that ultimately occurs in connection with this arrangement; and third – and perhaps most importantly – a long-term horizon during which the Fed's collateral will be safe-kept and, if sold, will be sold in an orderly fashion that is not affected by the unnaturally strong downward market pressures that have been associated with the recent liquidity crisis.

regulators (Bank of England, the Treasury and the FSA) could not detect the extent of the crisis and save the institution in spite of having a Tripartite Arrangement for information sharing and financial stability. On the other hand, in the US, the failure of Bear Stearns and other unfolding events have been dealt with in a pragmatic manner, despite there being no formal arrangements for co-operation among the various regulators, *viz.*, the Securities Exchange Commission, the New York Fed and the US Treasury. Similarly, the manner in which the financial crisis at American Insurance

Group (AIG) was handled reveals that in times of crisis, whether such interactions are under a formalised arrangement or otherwise, it is often the speed with which regulators react and interact within the existing framework that finally matters. However, there is the alternate view of a member that there is a need for formalisation of HLCCFM with a clear mandate. This, he felt, would be particularly important in times of crisis, for timely and effective crisis resolution.

**5.2.5 Cross-border Supervisory Co-operation**

Another major challenge regarding supervision is cross-border co-ordination. Financial conglomerates frequently have operations across countries and, thus, may be subject to potentially different capital and other supervisory requirements across jurisdictions. There is a need for effective and transparent co-operation between home and host regulators.

In India, over the past few years, in tandem with the growth in the economy, several Indian companies are expanding their footprint globally while foreign companies are setting up shop locally. As these companies widen their base and ultimately emerge as multinational entities, the domestic regulator needs to closely interact and co-ordinate with the overseas regulator for their effective supervision. In the case of banking and insurance regulators in India, effective co-operation with overseas regulators is constrained due to the existing laws. While information is currently being exchanged in an informal need-based manner, it is felt that the legal constraints impede the reaching of MoUs with overseas regulators.

The CFSA feels that issues relating to inter-regulatory co-ordination with overseas regulators have increased in importance in view of the enhanced need for supervision of cross-border financial intermediaries in the context of greater capital flows. While global financial integration through such intermediaries does have a beneficial impact, the volatility in capital flows can cause instability at critical times, especially in an emerging market economy like India, if they reflect changes in the risk appetite of international investors rather than a country's fundamentals. It also notes that an internal working group has been constituted by the Reserve Bank to lay down the roadmap for adoption of a suitable framework for cross-border supervision and supervisory co-operation. The CFSA, therefore, recommends early adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators through appropriate interpretation of the existing legal statutes and through legal amendments, if necessary, to enable signing of MoUs and joint inspections, in addition to effective supervision of banks or financial institutions that have cross-border presence. This would greatly strengthen the supervision of financial conglomerates. However, till the time of global agreement on cross-border co-operation is reached, the pros and cons of the arrangement need to be viewed before taking a firm decision.

Issues relating to inter-regulatory co-ordination with overseas regulators have increased in importance.

### 5.2.6 Reducing Scope for Regulatory Arbitrage

To reduce the scope of regulatory arbitrage, the Panels on Financial Stability Assessment and Stress Testing and Financial Regulation and Supervision underscored the requirement of effective regulatory co-operation, both domestic and across borders[101].

### 5.2.7 Enhancing Efficacy of Off-site Monitoring Through Close Co-ordination with On-site Supervision

The Reserve Bank monitors commercial banks and other financial institutions within its regulatory ambit through on-site inspection and off-site surveillance. These powers are derived from the BR Act. The Panel on Financial Regulation and Supervision observed that there is a need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising from the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision. The CFSA concurs with the Panel.

### 5.2.8 Overlapping of Regulation of Markets

The regulatory responsibilities over major financial market segments, *viz.*, money, government securities, foreign exchange, equities and bond markets are divided between two major regulators, *viz.*, the Reserve Bank and SEBI. The insurance and pension funds sectors are in the nascent stage which would fall under IRDA and PFRDA. A flow chart of the existing structure of financial market regulation in India is given in Table 5.1.

The regulatory role of the Reserve Bank in the financial markets has been clarified and strengthened under Section 45(W) of the RBI Amendment Act, 2006, wherein the Reserve Bank has been given specific power to 'regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time'. The directions issued under this sub-section shall not relate to the procedure for execution or settlement of the trades in respect of the transactions mentioned therein, on

[101] These aspects are examined in detail in Section 5.2.3 of the Advisory Panel on Financial Stability Assessment and Stress Testing as well as Chapter III Section 2.7 of the Advisory Panel on Financial Regulation and Supervision.

**Table 5.1: Existing structure of Financial Markets Regulation in India**

| Instruments | Regulator | SROs | Acts/ Guidelines | Trading platform/Regulation of trading/Market intermediaries |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| **Equities/corporate bond market**<br>i) Equities<br>ii) Corporate bonds other than money market instruments<br>iii) Collective Investment Schemes$<br>iv) Venture Capital<br>v) Derivatives related to equities<br>vi) Mutual Funds $$<br>vii) Public issue, listing and trading of securitised debt instruments | SEBI$$$ | Stock Exchanges are recognised as SRO under SC(R) Act. Presently there is no recognised SRO under SEBI SRO Regulation $$$$ | SEBI Act, 1992<br>SC(R) Act, 1956<br>Depositories Act, 1996<br>Companies Act, 1956$$$$$ | Stock exchanges$$$$$$. |
| **Government Securities Market**<br>i) Dated government securities &<br>ii) Derivatives on government securities market | RBI<br>SEBI | # | Government Securities Act, 2006 | Trading in government securitiess can take place in only dematerialised form and all the trades are settled in a guaranteed mode through CCIL in a DvP mode. |
| | | | SC (R) ACT, 1956 vide Govt. notification dated March 1, 2000. | As these instruments are listed on stock exchange provisions relating to SC(R) Act, 1956 shall be applicable and SEBI can take actions in respect of issues relating to listing and trading in RSE. Further, these securities can be traded through brokers and as brokers are regulated by stock exchanges who are in turn regulated by SEBI, any issues relating to brokers would fall under the purview of SEBI. Likewise, any transactions in RSE if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI. |
| | | | | The Reserve Bank has issued detailed guidelines to Primary Dealers## regarding management oversight, policy/operational guidelines, concurrent audit, provisioning, audit of brokers business, internal control systems, engagement of brokers for securities transactions, accounting standards to be followed for securities transactions (cf. IDMC. No.PDRS./2049A/ 03.64.00/99-2000 dated 31-12-1999). |
| **Money market**<br>i) Treasury bills<br>ii) Call money/notice money<br>iii) Term money | RBI | # | RBI Act, 1934<br>SC(R) Act, 1956 vide Govt. notification dated March 1, 2000 | The trading in money market instruments can take place on trading platform or in the OTC market. Electronic platforms are available for deals in Call, Notice and Term money transactions, market repo and CBLO. OTC deals are done for CP, CD as well as for Call/Notice/ Term money market. |

| Instruments | Regulator | SROs | Acts/ Guidelines | Trading platform/Regulation of trading/Market intermediaries |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| i) CPs*<br>ii) CDs** | RBI<br>SEBI | # | RBI Act, 1934<br>SC(R) Act, 1956 vide Govt. notification dated March 1, 2000<br>Companies Act, 1956 | OTC deals are done for CP, CD. As these instruments are listed on stock exchanges provisions relating to SC(R) Act shall be applicable and SEBI can take actions in respect of issues relating to listing. CPs can be traded through brokers and as brokers are regulated by stock exchanges who are in turn regulated by SEBI, any issues relating to brokers would be fall under the purview of SEBI. Likewise, any transactions in RSEs if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI. |
| Derivative products | RBI<br>SEBI | # | RBI Act, 1934<br>SC(R) Act 1956 vide Govt. notification dated March 1, 2000<br>SC(R) Act, 1956<br>Section 45U(a) of RBI Act | Standing Committee on Finance in its 25th Report published in 2005-06 stated that "there would be two statutes governing derivative transactions *viz.*, the SCR Act for exchange traded derivative transactions and RBI Act for OTC derivatives, which involve a Reserve Bank regulated entity as a party." The derivative products arising from money market instruments are regulated by the Reserve Bank. Section 16 of SC(R) Act states that Central Government in order to prevent undesirable of peculation in specified securities can by notification specify securities dealing in which is prohibited. Powers under Section 16 are exercisable by SEBI/the Reserve Bank. Section 13 of SC(R) Act empowers Central Government to notify states or areas where securities transactions entered into by individuals otherwise than between members of RSE would be treated as illegal. Powers under Section 13 are exercisable by SEBI also. Central Government or SEBI can regulate and control the business of dealing in spot delivery contracts in securities under Section 18(2) of SCR Act by issue of notification. |
| Interest rate futures | SEBI | # | | |
| Money market mutual funds&& | SEBI | Stock Exchanges | SC(R) Act 1956<br>SEBI Act, 1992 | The powers in respect of money market mutual funds vest with SEBI but money market instruments are defined by the Reserve Bank under Section 45U(b) of RBI Act. |

| Instruments | Regulator | SROs | Acts/ Guidelines | Trading platform/Regulation of trading/Market intermediaries |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| **Foreign exchange Market**<br>i) Foreign exchange products<br>ii) Derivatives on foreign exchange market | RBI | % | FEMA, 1999<br><br>SC(R) Act,1956 vide Govt. notification dated March 1, 2000<br><br>RBI Act, 1934 as amended in December 2005 | OTC products would not be listed on exchange. In terms of notification issued by Government of India, in March 2000, as foreign exchange products and its related derivatives would be regulated by the Reserve Bank. A number of trading platforms are presently available for market participants such as FX clear (promoted by CCIL), Fx Direct (promoted by IBS foreign exchange Ltd.), Reuters D2 and Reuters Market Data Systems (both promoted by Reuters). FX Clear and Fx Direct both offer real time order matching and negotiation modes for dealing. |
| **Gold related securities** | RBI<br><br>SEBI | - | SC(R) Act, 1956<br>SEBI, 1992<br>RBI, 1934<br><br>Banking Regulation Act, 1949<br><br>FEMA, 1999 | Listed on exchange. In terms of notification issued by Government of India, in March 2000, gold and its related securities would be under purview of the Reserve Bank. However, if the security is traded on exchange then SEBI also has powers inasmuch as it can take action in respect of issues relating to listing and trading of securities in RSE. Gold related securities can be traded through brokers and as brokers are regulated by stock exchanges who are in turned by SEBI, any issues relating to brokers would be fall under purview of SEBI. Likewise, any transactions in RSEs if they have been dealt with in a manner detrimental to investors, action can be taken by SEBI. |
| **Gold exchange traded funds** | SEBI | - | SEBI Custodian Regulations<br><br>SEBI Mutual Funds Regulation | The Gold ETFs are launched as mutual fund scheme by AMCs approved by SEBI. Units of Gold ETFs are listed and traded on exchange they would fall under the purview of SEBI. Terms of GETFs governed by Gazette notification dated January 12, 2006 and SEBI (MF) Regulations 1996. |
| **Gold futures** | FMC | - | Broad frame work for Forward Markets Commission<br><br>Guidelines have to be framed by respective exchanges. | Listed on MCX, NCDEX. Forward Contracts (Regulation) Act, 1952 provides for the powers and functions of FMC. The associations which provide platforms for trading in derivative contracts in commodities come under the regulatory purview of FMC.<br><br>Comprehensive powers have been given to FMC under ordinance issued in 2008 amending FCR Act |

| Instruments | Regulator | SROs | Acts/ Guidelines | Trading platform/Regulation of trading/Market intermediaries |
|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 |
| **Credit derivatives** | The Reserve Bank as regards RBI regulated entities SEBI in case such derivatives are traded on RSE | - | Banking Regulation Act, 1949<br>Chapter IIID of RBI Act<br>SCR Act – Section 18A. | As of now not listed.<br>SEBI in case such derivatives are traded on RSE. |

$ SEBI (Collective Investment Scheme) Regulations 1999 (CIS Regulations) states /provides that no person other than a Collective Investment Management Company which has obtained a certificate under the regulations can carry on a collective investment scheme. The CIS Regulation lays down legal and regulatory framework for launching and operating CIS schemes which comes under definition of CIS u/s 11AA of SEBI Act which includes agro bonds, teak bonds, plantation bonds *etc.* No entity has been registered with SEBI as CIS. As per regulation 9 (a) of CIS Regulations, 1999 the regulatory framework mandates that the form and structure of a CIS must be a company registered under Companies Act, 1956.

$$ SEBI (Mutual Fund) Regulations, 1996 (referred to as MF Regulations) set standards for the eligibility and regulation for those who wish to market a Mutual Fund Scheme. The Mutual Fund Regulation lays down legal and regulatory framework for schemes by which funds of investors are pooled to invest in securities, money market instruments, gold or gold related instruments, *etc.* Regulation 7 lays down eligibility criteria for registration of a Mutual Fund. Regulation 10 lays down terms and conditions of registration. Regulation 21 lays down eligibility criteria for appointment of Asset Management Company (AMC). Regulation 18(4) provides for requirement to be complied with before launch of any scheme. Regulation 28 lays down procedure for launching of Schemes of Mutual Fund.

$$$ SEBI has comprehensive inspection, investigation and surveillance powers. SEBI can call for information from, undertake inspection, conduct inquiries and audits of stock exchanges u/s 11(2)(i), MFs, other persons associated with securities market, intermediaries and SROs. SEBI can investigate without prior notice u/s 11C.

$$$$ Section 11(2)(d) of SEBI Act empowers SEBI to promote and regulate SRO. It has framed the SEBI (SRO) Regulations, 2004 (SRO Regulations) to enable organisation of intermediary to be recognised as SRO. As per Reg. 3 & 4 of SRO Regulations any applicant which seeks to be recognised as SRO should have the capacity to carry out the purposes for which it is seeking recognition. There are also other organisation such as Association of National Exchanges Members of India (ANMI), Association of Mutual Funds of India (AMFI), Association of Merchant Bankers of India (AMBI) and Financial Planning Standards Board of India (FPSBI). The organisations like ANMI, AMFI, AMBI, FPSBI *etc.* at present function primarily as trade association.

$$$$$ SEBI has power of inspection over listed companies u/s 209A of Companies Act.

$$$$$$ The SC(R) Act has laid down legal and regulatory framework for recognition /authorisation and operation of the RSE and regulations of contract in securities. Section 19 of SC(R) Act prohibits stock exchanges (SEs) other than RSEs. Any SE desirous of being recognised as RSE, has to make an application for recognition to SEBI, as per Section 3 of SC(R) Act. The RSE may establish trading floor with prior approval of SEBI, on terms and conditions stipulated by SEBI as per Section 13A of SC(R)

Act. Derivative Exchanges or separate derivative segment of an existing exchange also require approval from SEBI. Section 17(A) of SCR Act inserted by SC(R) Amendment Act, 2007 w.e.f 28.5.07 empowers SEBI to regulate public issue, listing and trading of securitised debt instruments.

# Though, FIMMDA and PDAI do SRO like function for government securities market, they are not SROs. Likewise, though, FIMMDA does some SRO like function for money market, they are not SROs. FIMMDA stands for The Fixed Income Money Market and Derivatives Association of India (FIMMDA). It is an Association of Commercial Banks, Financial Institutions and Primary Dealers. FIMMDA is a voluntary market body for the bond, Money and Derivatives Markets. FIMMDA has members representing all major institutional segments of the market. The membership includes Nationalised Banks such as State Bank of India, its associate banks, Bank of India, Bank of Baroda; Private sector Banks such as ICICI Bank, HDFC Bank, IDBI Bank; Foreign Banks such as Bank of America, ABN Amro, Citibank, Financial institutions such as ICICI, IDBI, UTI, EXIM Bank; and Primary Dealers. The objectives of FIMMDA are

- To function as the principal interface with the regulators on various issues those impact the functioning of these markets.
- To undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments, *etc.*
- To provide training and development support to dealers and support personnel at member institutions.
- To adopt/develop international standard practices and a code of conduct in the above fields of activity.
- To devise standardised best market practices.
- To function as an arbitrator for disputes, if any, between member institutions.
- To develop standardised sets of documentation.
- To assume any other relevant role facilitating smooth and orderly functioning of the said markets.

(Source: FIMMDA website)

##PDs' role and obligations

PDs are required to have a standing arrangement with the Reserve Bank based on the execution of an undertaking each year. The major roles and obligations of PDs are as below:

i) Support to Primary Market: PDs are required to support auctions for issue of government dated securities and Treasury Bills as per the minimum norms for bidding commitment and success ratio prescribed by the Reserve Bank from time to time.

ii) Market making in Government securities: PDs should offer firm two-way quotes in Government securities, through the Negotiated Dealing System, over the counter telephone market and through recognised Stock Exchanges in India and take principal positions in the secondary market for Government securities.

iii) PDs should maintain minimum capital standards at all points of time as prescribed by the Reserve Bank.

iv) PDs should achieve minimum turnover ratio of 5 times for Government dated securities and 10 times for Treasury Bills of the average month-end stocks (turnover ratio computed as the ratio of total purchase and sales during the year in the secondary market to average month-end stocks) in the secondary market for Government dated securities and Treasury Bills.

v) PDs' operations are subject to all prudential and regulatory guidelines issued by the Reserve Bank.

(cf. IDMD.PDRS.05/03.64.00/2004-2005 dated October 1, 2004)

* Guidelines on CPs issued by the Reserve Bank vide FMD.No.6/02.06.001/2006-07 dated July 13, 2006

** Guidelines on CDs issued by the Reserve Bank vide FMD.No.7/02.06.001/2006-07 dated July 13, 2006

& Trading in government securities over exchanges (cf. IDMC.PDRS.No.2896/03.05.00/2002-03 dated January 14, 2003)

With effect from January 16, 2003, trading of dated Government of India (GOI) securities in dematerialised form is being allowed on automated order driven system of the National Stock Exchange (NSE), The Stock Exchange, Mumbai (BSE) and the Over the Counter Exchange of India (OTCEI). This is in addition to the present system of trading in government securities. Being a parallel system, the trades concluded on the exchanges will be cleared by their respective clearing corporations/

clearing houses. The trades of Primary Dealers have to be settled either directly with clearing corporation/clearing house (in case they are clearing members) or else through clearing member custodian.

Primary Dealers (PDs) are expected to play an active role in providing liquidity to the government securities market and promote retailing. With a view to facilitating participation on the Stock Exchanges within the regulations prescribed by the Reserve Bank, SEBI and the exchanges, the PDs are being extended following facilities:

a. PDs may open demat accounts with a Depository Participant (DP) of NSDL/CDSL in addition to their accounts with the Reserve Bank.

b. Value free transfer of securities between SGL/CSGL and demat accounts would be enabled by PDO-Mumbai subject to operational guidelines being issued by our Department of Government and Bank Accounts (DGBA) separately.

PDs should take specific approval from their Board of Directors to enable them to trade in the Stock Exchanges. PDs should put up an effective internal control system and enabling IT infrastructure to track the orders executed for settlement / reconcile balances with the custodians, *etc.* As in the case of equities, PDs as institutional investors, would be exempted from margin requirements. As a consequence, they can undertake transactions only on the basis of giving and taking delivery of securities. Brokers/trading members shall not be involved in the settlement process; all trades have to be settled either directly with clearing corporation/clearing house (in case they are clearing members) or else through clearing member custodians. The trades done through any single broker will also be subjected to the current regulations on transactions done through brokers. At the time of trade, securities must be available with the PDs either in their SGL or in the demat account. Any settlement failure on account of non-delivery of securities/non-availability of clear funds will be treated as SGL bouncing and the current penalties in respect of SGL transactions will be applicable. Stock Exchanges will report such failures to the respective Public Debt Offices. PDs who are trading members of the Stock Exchanges may have to put up margins on behalf of their non-institutional client trades. Such margins are required to be collected from the respective clients. PDs are not permitted to pay up margins on behalf of their client trades and incur overnight credit exposure to their clients. In so far as the intra day exposures on clients for margins are concerned, the PDs should be conscious of the underlying risks in such exposures. PDs who intend to offer clearing /custodial services should take specific approval from SEBI in this regard. Similarly, PDs who intend to take trading membership of the Stock Exchanges should satisfy the criteria laid down by SEBI and the Stock Exchanges.

&& MFD/CIR/1/189/2000 dated April 10, 2000

The Reserve Bank has withdrawn its guidelines issued in 1992 on money market mutual funds (MMMFs) w.e.f. March 7, 2000. Accordingly, such money market mutual fund schemes, like any other mutual fund schemes, would exclusively be governed by the SEBI (Mutual Funds) Regulations,1996

- In case of foreign exchange market, Foreign Exchange Dealers Association of India (FEDAI) though recognised as an SRO by the Reserve Bank since August 1958 acts more in the nature of an industry level body representing the authorised dealers (banks and other players who are authorised to deal in foreign exchange). The major activities of FEDAI include framing of rules governing the conduct of inter-bank foreign exchange business among banks *vis-à-vis* public and liaison with the Reserve Bank for reforms and development of foreign exchange market. However, as required in terms of IOSCO Principles it does not establish any eligibility criteria that must be satisfied in order for individuals or firms to participate in activities in foreign exchange markets thereby not fulfilling the basic tenet of an SRO. Further, FEDAI is also not within the regulatory jurisdiction of the Reserve Bank. Some more empowerment of FEDAI is necessary for its transition to a full-fledged SRO.

**Source :** Advisory Panel on Financial Regulation and Supervision.

the Stock Exchanges recognised under Section 4 of the Securities Contracts (Regulation) Act, 1956.

The Reserve Bank regulates the government securities and money markets and derives its regulatory powers from the RBI Act (Chapter III D – Section 45 W), Securities Contracts Regulation Act 1956(SCRA), the RBI Act and Government Securities Act, 2006. To the extent government securities are listed and the securities and related derivatives are traded in stock exchanges, some aspects relating to government securities, money and foreign exchange market regulations are shared by SEBI. Thus, exchange traded currency futures that have been recently introduced involved co-ordinated action from the Reserve Bank and SEBI. The CFSA notes that similar efforts are in progress in activating interest rate futures.

As evident from the functions of SEBI, it is vested with the task of investor protection and regulating various market intermediaries. Section 11C of the SEBI Act, 1992 states that SEBI can look into cases where it has reasonable grounds to believe that transactions in securities are being dealt with in a manner detrimental to investors or the securities market; or any intermediary or any person associated with securities market has violated any of the provisions of the Act or rules or regulations made or directions issued by SEBI thereunder. Further, as per Section 12 of the SEBI Act, no market intermediary who may be associated with the securities market shall buy, sell or deal in securities except in accordance with the condition of certificate of registration obtained from SEBI. SEBI has made regulations for various intermediaries, including stockbrokers.

SEBI is empowered to frame regulations or file prosecution without the approval of the Central Government. SEBI is able to operate and exercise its powers without external political and commercial interference. The Ministry of Corporate Affairs has concurrent powers under the Companies Act in respect of matters relating to the capital market, such as the prospectus and issue of shares to the public. Even though Section 55A empowers SEBI to administer provisions of the Companies Act in respect of issues, the transfer of securities and the non-payment of dividends in respect of listed or proposed to be listed companies, SEBI does not have the power to make regulations. Only the Central Government has the power to make rules and prescribe schedules, including in respect of prospectus and financial statements. The Panel on Financial Regulation and Supervision recommended that all capital market-related matters in respect of listed companies should be exclusively in SEBI's domain including the power to make regulations in respect of matters specified under Section 55A.

All capital market-related matters in respect of listed companies should be exclusively in SEBI's domain.

During the initial phase of growth of the insurance sector, Unit Linked Insurance Plans (ULIPs) were seen to be analogous to equity-linked savings scheme (ELSS) and similar mutual fund schemes. ULIPs are issued by insurance companies (regulated by IRDA), whereas mutual fund schemes are issued by mutual funds (regulated by SEBI), the two operating under different

A co-ordinated view should be taken towards overlap and conflict of regulatory jurisdictions.

prudential norms. New guidelines issued by IRDA in 2006 have stopped ULIPs from being positioned as short-term investment products. In order to ensure that such different saving instruments with short- and long-term investment objectives are positioned appropriately to reflect their respective positions, steps are being taken towards inter-regulatory co-operation on an ongoing basis.

The CFSA feels that a co-ordinated view should be taken towards overlap and conflict of regulatory jurisdictions, taking on board the various regulations in this regard. If required, appropriate amendments could be made to mitigate the conflicts arising from regulatory overlap.

### 5.2.9 Capacity building

The advent of liberalisation and opening up of economies has seen the new private sector banks along with foreign banks competing aggressively with public sector banks (PSBs) for business. Launching innovative products to cater to the varied needs of their customers has become the order of the day. Given their incentive structure, PSBs find it difficult to attract people with the required skill-sets who could participate and also cope with financial innovations, pointing towards the urgency of capacity building. Second, while acknowledging that key financials in the PSBs have improved in recent years and have led to a convergence of performance parameters among various bank groups, it remains doubtful how much of this convergence can be sustained in the event of an economic downturn, given the risk management skills in these banks. The issue of capacity building thus gains further importance with new areas like risk management and Basel II gaining predominance. With the ongoing integration of financial markets and diversification of asset classes, such capacity building also assumes importance in the insurance and securities markets.

Demand for expertise in risk-based supervision, credit and operational risk management is likely to increase significantly in the next few years.

In its Report 'Implementation of Basel II — Implications for the World Bank and the IMF' in July, 2005, the IMF stated that to build their supervisory capacity, countries will need to recruit additional specialised staff and provide extensive training to existing staff on Basel II. The Financial Stability Institute's (FSI) Survey on Implementation of the new capital adequacy framework (2005) estimates that responding countries could require training of over 9,000 supervisors. Demand for expertise in risk-based supervision, credit and operational risk management is likely to increase significantly in the next few years. In most countries, supervisory agencies, operating under government pay scales, will be disadvantaged in competing against the private

sector for these skills. The prospect of a 'brain drain' of Basel II-trained supervisors to the private sector is very real, further challenging the ability of supervisory agencies to build the necessary capacity to implement Basel II.

It will never be easy for the regulator to match the ever-increasing remuneration levels of industry.

Migration to Basel II norms presupposes familiarity and expertise with quantitative techniques and statistical methods. The Advisory Panel on Financial Regulation and Supervision has stated that there is a need for capacity building, both from the perspective of the regulated and the regulator. Further, lateral recruitment of specialists with the requisite skill-sets, the incentive structure and appropriate compensation package, in keeping with the times and relatively aligned with general market trends, and the need to look into HR policies including transfer policies in the banking sector (particularly the PSBs) have been emphasised. This should also factor in the fact that the central bank, besides being a regulator, is also a monetary authority. Likewise, in the case of SEBI, capacity building and skill enhancement are issues, particularly with various innovations and new developments in the securities market.

As regards the insurance sector, Mr. Sheng pointed out that large economies with sector-specific risk-needs may be fertile ground for innovative insurance schemes. He stressed on the training of actuaries, which is fundamental to risk management, not only in insurance but also in the rest of the financial sector. While concurring with Mr. Sheng's views, the Panel on Financial Stability Assessment and Stress Testing highlighted the need for insurance staff to also develop their treasury function and investment management skills. In order to effectively monitor the sector, IRDA needs to take steps to strengthen its machinery in terms of adequate skills for its officials, which would require capacity building.

The Panel on Financial Regulation and Supervision accords importance to capacity building of the regulators as a serious issue and recommends a market-related incentive structure to attract and retain talent with added attention to training and development. The CFSA notes that worldwide there is a difference between the incentive structure of commercial private market entities and regulators. Regulators get the opportunity to work on a wider canvas and frame policies which have implications at the national level. The job provides an opportunity to represent the country at international fora and also gives greater research opportunities to members of the staff. Given the difference in the work environment and job content between the regulators and private market entities, there is bound to be some difference in the respective incentives structures and it may be more appropriate for the regulator to aspire for an 'adequate' incentive structure which has the capacity to attract and retain talent and qualified professionals rather than aiming at market-related packages. The CFSA agrees with the approach taken by the Panel that in the Indian context it will never be easy for the regulator to match the ever-increasing remuneration levels of industry. But it has to be ensured that the gap between the two remains manageable and the efficacy of the system is not undermined.

It may be more appropriate for the regulator to aspire for an 'adequate' incentive structure.

The Advisory Panel on Financial Stability Assessment and Stress Testing has noted in this context that issues confronting the PSBs, in particular, relate to seniority-based promotion, limited performance incentives, inadequate compensation policies and adverse age profile. They felt that PSBs needs to undertake a thorough assessment of the competence level of officers and their redeployment tailored to skill levels in order to address the gap in the medium term. There is a need to develop a comprehensive HR policy, as opposed to a personal administration policy, for better utilisation and deployment of their resources. This will entail revamping the entire eco-system of their functioning, including attracting the best talent, empowering them to take decisions that exploit their skill-sets, developing structured programmes to upgrade their skills on a continuous basis and incentivising performance. Developing imaginative ways of retaining talent including enhanced career planning, exploiting opportunities and improving compensation packages are integral to the process. Bank boards also need to be empowered to take decisions and provided with the freedom to evolve and implement policies on recruitment, empowerment, retention, devising reward structures and appropriate skill development programmes. Finally, issues of continuity in top management and succession planning, particularly at the top level, need to be addressed.

The CFSA emphasises that with aspects like the need for financial innovations and improving risk management in the context of Basel II gaining predominance against the backdrop of increasing globalisation in the banking sector, commercial banks in general and PSBs in particular have to build their staff competence. It endorses the stand taken by both the Panels and feels that issues relating to incentive structure, recruitment, promotion, retention, training, transfer, and succession plans be addressed, which in turn could help alleviate the inherent constraints related to capacity building in the banking sector.

Issues relating to recruitment, incentive structure, promotion, retention, training, transfer and succession plans need to be addressed.

As pointed out by the Panel on Financial Regulation and Supervision, the CFSA also underscores the need for regulators to take steps in capacity building including improvements in compensation structure. Regulators cannot lag behind market players and they run a huge risk if they do not have expertise in areas of risk management, Basel II, and derivatives, or are not in a position to appreciate the implications of new products and market innovations. In this context, it notes that regulatory institutions have taken various training initiatives (Box 5.5).

**Box 5.5: Recent Training Initiatives by Regulatory Institutions**

**Reserve Bank of India**

In recent times, the Reserve Bank has taken a number of capacity building initiatives like signing of MoUs with the reputed institutions like the London School of Economics and Political Science (LSE) to create an LSE-India Observatory and IG Patel Chair for co-ordinating India-related research, policy development and teaching at the LSE. This is expected to emerge as a hub for academic collaboration with academic institutions in India, government agencies and corporate bodies. It has also introduced an incentive scheme for pursuing part-time and distance education courses in areas like management, information technology, and financial analysis, and a post-graduation course in commerce and economics for its staff. Between July, 2006 and June, 2007, 555 employees availed of the scheme. Other than the in-house training programmes conducted by the Reserve Bank, more than 1,200 officials from the Reserve Bank were deputed for training in various institutions, both in India and abroad.

**SEBI**

Several training initiatives were undertaken during 2006-07 to enhance the skills and efficiency of staff members. Staff members were deputed for training programmes/seminars both within India and abroad. During 2006-07, 162 staff members were exposed to 67 training programmes. HRD, in collaboration with the National Institute of Securities Markets (NISM), organised a one-week residential training programme on 'Leadership and Employee Engagement' for General Managers, and 'Personnel and Managerial Effectiveness' for Deputy General Managers. SEBI sends officials for training programmes/conferences/seminars held by international bodies such as IOSCO, IMF, OECD and ADB, and financial market regulation programmes organised by securities market regulators of developed markets. During 2006-07, 17 officials from SEBI were sent for 13 such training programmes/conferences/seminars.

**IRDA**

As an integral part of the growth of the Authority, development of human resources skills has been given due importance so as to perform its role more skilfully, efficiently and effectively. A new Inspection Wing has been set up by the Authority to inspect the various licensed insurance entities. The International Association of Insurance Supervisors (IAIS), established in 1994, has representatives from some 100 insurance supervisory authorities. It was formed to promote co-operation among insurance supervisory authorities, set international standards for insurance supervision and regulation, provide training to members and co-ordinate work with regulators in other financial sectors and international financial institutions. The Authority, jointly with the Andhra Pradesh Government, set up an Institute of Insurance and Risk Management (IIRM) at Hyderabad in 2002. IIRM aims to serve the learning and development needs of emerging markets in the context of contemporary challenges. It continues to cater to the needs of the industry by providing a range of courses, including a post-graduate diploma in general insurance, life insurance and risk management.

**Source :** Annual Reports of RBI, SEBI and IRDA

In this context, the CFSA recommends that the following measures could be considered:

(i) Identify people with the right skill-sets for the right jobs within the existing staff.

(ii) Recruit laterally from the market, at middle and top management levels, experts with professional competence and the requisite skill-sets.

(iii) Develop a core team in each area that requires technical expertise and focused attention, *e.g.*, risk management, derivatives, and product innovation.

(iv) Re-examine the transfer policy to enable competent people to be retained in their core areas of expertise.

(v) Increase training in areas, such as risk management and derivatives, and dovetail the training requirements with postings. The training programmes should be more systematic and focused on the development of core competence.

(vi) Streamline systems and procedures within the institutions, facilitating flexibility and improved and faster decision making.

(vii) Develop an appropriate incentive structure in terms of pay packet, career progression, and performance incentives, to attract and retain talent which should be in tune with changing times.

(viii) Develop a second line of professionals and have an appropriate succession plan, thereby augmenting institutional memory.

**5.2.10 Summary**

A robust and secure financial infrastructure is the cornerstone of financial stability and development.

*Regulatory structure*

The Indian financial system has evolved over time and so is the case with the numerous regulatory bodies that characterise its regulatory structure. The presence of several regulators and the multiplicity of roles and objectives assigned to them can potentially introduce conflicts of interest. Potential conflicts also arise because regulatory agencies, particularly the Reserve Bank, also own some of the financial institutions over which they have regulatory and supervisory oversight. Also, several regulatory/ supervisory agencies are mandated with a market development role, and other such functions. The CFSA, however, is of the view that the presence of multiple regulators is consistent with the transitional phase of financial development. The real issue lies in the co-ordination of the financial policies which have often been found to be lacking even in a super-regulator environment.

There has been a recent debate on the virtues of the two approaches to regulation – principles-based and rules-based. The conflict between principles- and rules-based regulations arises from a perceived notion of 'false

dichotomy'. Principles-based and rules-based approaches to financial regulations are complementary and not mutually exclusive. The right approach would be to group the existing rules according to a few broad sets of principles and to check whether they satisfy these principles. This would also obviate the rules/regulations degenerating into ad-hocism. Recognising the varied stages of development of players across markets and institutions, it is believed that there would be a need for separate sets of rules for different regulated entities within the broad parameters earmarked in the principles.

*Supervision of Financial Conglomerates (FCs)*

Regulation and monitoring of the financial operations of large and complex financial organisations or Financial Conglomerates (FCs), pose significant problems as they often create new prudential risks while exacerbating existing ones. Conglomerate supervision in India is still in its early stages of evolution and implementation, both on a domestic and on a cross-border basis.

The most common structure of financial conglomerates in India is based on the operating subsidiary model. At present, there is no legislation specifically permitting regulation of FCs and holding companies in India. There is a requirement of legislating a new law in this regard. The central bank could, in the interests of financial stability, be armoured with enough supervisory powers and also monitoring functions in respect of FCs. In the Indian context, the following steps can be considered:

(i) In the case of an FC where the apex institution is a bank holding company, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank.

(ii) In the case of an FC with a non-bank holding company (financial or non-financial) having a bank within its structure, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank.

(iii) In the case of an FC with a non-bank financial holding company whose activity is within the regulatory jurisdiction of the Reserve Bank, the responsibility for regulation and supervision of the holding company would lie with the Reserve Bank irrespective of whether there is a bank within its structure.

(iv) In the case of an FC with non-financial holding company, the holding company should be explicitly within the regulatory outreach of the Reserve Bank, to the extent that the Reserve Bank is empowered to obtain information as relevant from time to time, even if there does not exist a bank within the FC structure.

(v) As in the case of the FRB's role in the US as umbrella supervisor, the interactive relationship between the Reserve Bank and other regulators of sectors such as insurance, securities, and housing, needs to be streamlined.

However, allowing 'intermediate' holding companies may not be feasible until an appropriate regulatory structure for such an entity is in place.

In addition to the 'silo plus' FC supervisory system, each FC could report to a 'Lead Regulator' which would exercise regulatory and supervisory authority in relation to the entity's primary function. Supervision of entities with businesses cutting across different regulatory domains could be conducted collaboratively by the regulators with the lead regulator co-ordinating the supervision across various jurisdictions, subject to the parameters of co-ordination being well-defined and ground rules being specified. Entities under the FC that function in a regulatory vacuum should be brought under the regulatory reach of the lead regulator. It would be the responsibility of the lead regulator to co-ordinate with the Reserve Bank in case the FC is of a holding company structure. The CFSA endorses the Reserve Bank's initiative to insert Clause 29 A in the BR Act, giving the Reserve Bank powers to inspect the books of accounts and other records of all entities that are subsidiaries/associates of a bank, and suggests a similar change in law for other lead regulators. It also notes that an approach paper on regulatory and supervisory framework for monitoring of financial conglomerates is being finalised.

A unified regulatory environment is not without its pitfalls and there is a need to strengthen inter-regulatory co-operation between the Government and regulators in the interests of financial stability. In the Indian context, while LoLR as also regulatory and supervisory functions are conducted by the Reserve Bank, an arm's length relationship between the Board for Financial Supervision and monetary function, including the LoLR, already exists. Any further separation of the two functions could lead to loss of synergies between the regulator, monetary authority and LoLR from the stability perspective.

*Self-Regulatory Organisations*

The visible advantages of SROs and their importance lie in lessening the burden of the regulator and allowing it to focus on policy issues. They may also be able to respond more quickly and flexibly than the regulator to changing market conditions. With self-regulation in place, not only could market misconduct be reduced significantly but the pace of development could also increase since industry and regulator would align their efforts towards a common goal. Finally, a self-regulation culture could help increase investor confidence and keep the momentum of market development at a steady pace.

At the same time, formal oversight by the regulator in respect of the SROs is a necessity. A careful study of the arm's length relationship of SROs with the associated trade bodies and their corporate governance policies could be ensured by the regulator before according SRO status to avoid potential conflicts of interest. Granting SRO status to an institution would necessitate the fulfillment of certain preconditions. It will require regulators to introduce transparent policies for defining, identifying, and approving SRO status to institutions which are already performing implicitly or more explicitly self-regulatory functions in the financial sector. This could be the first step to pave the way for evolving generalised policies towards self-regulation, after some experience is gained in the functioning of these organisations. The regulatory initiatives in this regard are inadequate and there are considerable ambiguities about the status of certain organisations, such as FEDAI in the foreign exchange market and stock exchanges in the securities market. Institutions such as AMBI, ANMI, AMFI, and FPSBI did not assume the role of SROs due to stringent guidelines as evidenced from interaction with SEBI. However, SEBI is in the process of modifying SRO regulations in consultation with international agencies.

*Independence of regulatory and supervisory authority*

The independence of financial regulatory agencies is important for financial stability for many of the same reasons that central bank independence matters. Of the three major regulatory agencies in India, while SEBI is empowered to frame regulations without the approval of the Central Government and operate and exercise its powers given under the above Acts without external political and commercial interference, there are certain legal provisions in the SEBI Act which restrict its independence. However, the Government feels that under Section 16 of the SEBI Act the Government has the powers to issue directions on questions of policy and this needs to be given in writing. The questions of policy are decided by the Government as is the case with other self-regulating agencies. As regards the Government's power to supersede the SEBI board and powers to call for information from SEBI, this in no way dilutes the regulatory autonomy of SEBI. Further, it also needs to be noted that the Ministry of Finance has never exercised these powers *vis-à-vis* any statutory regulatory agencies.

The IRDA is an independent agency which reports to Parliament through the Ministry of Finance.

Though the Reserve Bank enjoys autonomy in respect of framing regulations and issuing directions to banks and also legal protection for its actions, the Central Government may remove the Governor or Deputy Governor from office without specifying any reasons. However, considering the Reserve Bank's success as a regulator amidst its diverse activities, and also the fact that by convention the Reserve Bank's independence is fairly well established, there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/Deputy Governor could be removed.

Regulators provide a public good at a cost which underscores the need to maintain their financial independence.

*Domestic Regulatory Co-operation*

The existence of multiple regulators is consistent during a transitional phase of financial development. At present, co-operation and information sharing between the regulatory agencies is handled by a formal standing committee – the High Level Co-ordination Committee on Financial Markets (HLCCFM) – to address matters which have a bearing on the financial and capital markets. It has been recommended by various Advisory Panel that this arrangement needs to be institutionalised and brought under a formal and transparent arrangement and various measures to strengthen it have also been suggested. Further, one of the members of the CFSA also felt that formalisation of HLCCFM with a clear mandate would be particularly important in times of crisis for timely and effective crisis resolution. CFSA, however, feels that while, for effective regulation and supervision and in the interests of financial stability, the issues of regulatory co-ordination have become increasingly crucial, institutionalisation and formalisation of the co-ordination arrangements in a stringent fashion might turn out to be counter-productive.

*Cross-border Supervisory Co-operation*

Issues relating to inter-regulatory co-ordination with overseas regulators have increased in importance in view of the enhanced need for supervision of cross-border financial intermediaries in the context of greater integration with external markets. Early adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators is needed through an appropriate interpretation of the existing legal statutes and undertaking legal amendments, if necessary. This will enable signing of MoUs and joint inspections, in addition to effective supervision of banks or financial institutions having cross-border presence. However the pros and cons of such an arrangement needs to be viewed before taking a firm decision.

*Co-ordination Between On-site Supervision and Off-site Monitoring*

There is a need as well as room for enhancement of co-ordination between on-site inspections and off-site surveillance to exploit fully the synergies arising from the complementarity of these two forms of supervision. Suitable measures to achieve this objective are called for as these will add substantially to effective supervision.

*Overlapping of Regulation of Markets*

The overlap in market regulations between the Reserve Bank and SEBI has been considerably addressed through appropriate legislations. There remains significant overlap between SEBI and the Ministry of Corporate Affairs in respect of matters related to equity and corporate debt markets.

Also, there are certain competing products which are issued by different sets of institutions that fall under different regulatory regimes. This raises questions regarding a level playing field for marketing in respect of such products. A co-ordinated view could be taken in respect of overlap and conflict of regulatory jurisdictions, taking on board the various regulations in this regard.

*Capacity Building*

With new areas like risk management and Basel II gaining predominance, there is a need for capacity building both from the perspective of the regulated and the regulator. Further, in the ongoing integration of financial markets and diversification of asset classes, such capacity building also assumes importance in areas like insurance and securities markets.

The capacity building of regulators is also a serious issue and a market-related incentive structure to attract and retain talent and added attention to training and development are necessary. Given the difference in the work environment and job content between the regulators and private market entities, it may be more appropriate for the regulator to aspire for an 'adequate' incentive structure that would enable them to attract and retain talent and qualified professionals, rather than aiming at fully market-related packages.

In this context, the following measures could be considered:

(i) Identify people with the right skill sets for the right jobs within the existing staff.

(ii) Recruit laterally from the market, at middle and top management levels, experts with professional competence and the requisite skill-sets.

(iii) Develop a core team in each area that requires technical expertise and focused attention, *e.g.*, risk management, derivatives, and product innovation.

(iv) Re-examine the transfer policy to enable competent people to be retained in their core areas of expertise.

(v) Increase training in areas, such as risk management and derivatives, and dovetail the training requirements with postings. The training programmes should be more systematic and focused on the development of core competence.

(vi) Streamline systems and procedures within the institutions, facilitating flexibility and improved and faster decision making.

(vii) Develop an appropriate incentive structure in terms of pay packet, career progression, and performance incentives, to attract and retain talent which should be in tune with changing times.

(viii) Develop a second line of professionals and having an appropriate succession plan, thereby augmenting institutional memory.

## 5.3 Liquidity Infrastructure

Systemic liquidity infrastructure refers to a set of institutional and operational arrangements - including key features of central bank operations and money and securities markets - that have a first-order effect on market liquidity and on the efficiency and effectiveness of liquidity management by financial firms[102]. Aspects related to liquidity infrastructure from the stability perspective were analysed by the Panel on Financial Stability Assessment and Stress Testing. The Panel has noted that till end of 2007, large capital inflows have necessitated the Reserve Bank to sterilise the excessive monetary impact of inflows, using the market stabilisation scheme (MSS)[103], cash reserve ratio (CRR)[104] and Open Market Operations (OMO). There has been symmetric treatment of large capital outflows with respect to these instruments during 2008-09.

Though there is a difference between the liquidity absorption of a more enduring nature by way of sterilisation through MSS or CRR, and the day-to-day normal liquidity management operations through liquidity adjustment facility (LAF)[105], the total absorption of liquidity from the system by the Reserve Bank in line with the monetary policy stance from time to time gets reflected in the use of instruments of LAF, MSS and OMOs. It has been observed that the operation of LAF can sometimes be constrained by the availability of securities with the Reserve Bank when the liquidity has to be absorbed, and with the availability of SLR surplus securities with the market participants if they have to avail liquidity from the Reserve Bank. Some

The operation of LAF can sometimes be constrained by the availability of securities with the Reserve Bank or the market participants.

[102] Dziobek, C., Hobbs, J.K., and Marston, D. (2000) as quoted in Handbook on Financial Sector Assessment, World Bank and IMF, September 2005.

[103] The Reserve Bank's Internal Working Group on Instruments of Sterilisation recommended in April, 2004 a scheme for launching market stabilisation bonds to absorb excess liquidity of a more enduring nature. Under this arrangement, the Central Government issued Treasury Bills and /or dated securities in addition to the normal borrowing requirements for absorbing excess liquidity from the system.

[104] The current CRR is at 5 per cent of net demand and time liabilities of banks.

[105] Liquidity Adjustment Facility (LAF) is operated by the Reserve Bank to inject/absorb liquidity through daily repos/reverse repos auctions.

seasonal and uncertain influences in system liquidity also continue to be prevalent, causing volatility in overnight rates.

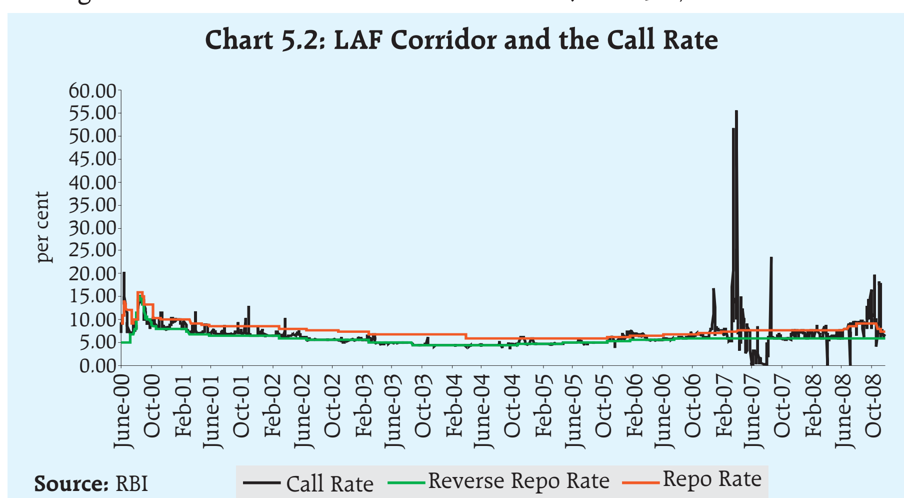
### 5.3.1 Volatility in Overnight Rates

In India, there are mainly two rates through which the Reserve Bank signals a change in interest rates: a lending rate (Repo rate) and a borrowing rate (Reverse repo rate) for overnight funds. These constitute a 'corridor' within which overnight interest rates usually move. The movement of overnight rates has often witnessed spikes at the end of each quarter due to advance tax payments and year-end considerations for banks. In contrast during the period December, 2006 to August, 2007 when the Reserve Bank introduced a cap of Rs.3,000 crore on funds parked daily by banks with it through the reverse-repo facility, the market generally witnessed surplus liquidity resulting in a sharp fall in interest rates (Chart 5.2).

This volatility has been accentuated by the difficulties in estimating cash flows with any reasonable degree of accuracy in the government accounts, largely arising from difficulties in projecting the receipts and payments of Governments. The Panel felt that there is, therefore, a requirement to strengthen the management of government cash balances. In this context, it might be worthwhile to consider introducing auctions of the Central Government surplus balances with the Reserve Bank in a non-collateralised manner, which would also make available the government securities in the Reserve Bank's investment books for its own market operations. Other than reduction in volatility of overnight rates resulting in a more efficient money market, the Government could also expect a reasonable return on its idle cash balances. The CFSA feels that systems and procedures need to be developed to smooth out well-known spikes in call money rates arising out of the quarterly tax payments. The CFSA also feels that the recommendations of the Panel could be considered by the Government/ Reserve Bank.

In spite of the high depth, the overnight segment of the money market shows some volatility due to lack of liquidity, even though volatility in overnight rates has come down in recent times (Table 5.2).

**Chart 5.2: LAF Corridor and the Call Rate**




**Source:** RBI

It might be worthwhile to consider introducing auctions of the Central Government surplus balances with the Reserve Bank in a non-collateralised manner.

Capacity building in banks and the Reserve Bank, for more accurate liquidity forecast, is required.

**Table 5.2: Volatility in Money Market Rates**

| Item | April 1993 - March 1996 | April 1996 - March 2000 | April 2000 - June 2008 |
|---|---|---|---|
| **Call Money** | | | |
| Average (per cent) | 11.1 | 8.0 | 6.3 |
| Standard Deviation | 6.7 | 3.7 | 1.9 |
| Coefficient of Variation | 0.6 | 0.5 | 0.3 |

**Note :** Calculated on monthly average data
**Source :** RBI - RCF 2006

The management of overnight temporary liquidity is dependent on accurate liquidity forecasts, which currently are not very precise. There is also a requirement of skill development of the market participants to assess their own liquidity requirements. This requires strengthening of the asset-liability management of banks, including the development of the term money market. Also the ability of the monetary authority to develop appropriate liquidity forecasting models becomes important. This, together with improved government cash management practices will ensure a better ability to forecast the day-to day-liquidity swings in the system. The CFSA notes that a Working Group in the context of better cash management by the Government has been set up. The CFSA agrees with the Panel and feels that both banks and the Reserve Bank should address the issues related to capacity building in this regard. There is also the need to refine the liquidity indicators. This is necessary both for better monetary/credit management and for minimising systemic risk and financial crisis propagation.

### 5.3.2 Limitation of LAF Operations

Accepting collaterals such as high-quality AAA-rated paper for conducting repos can be explored.

A fallout of the introduction of LAF has been the passive role adopted by some banks in managing their day-to-day liquidity position. The LAF operations are also constrained by the non-availability of securities both with the Reserve Bank, when liquidity has to be absorbed, and with the market participants, when they are in need of liquidity. The Panel felt that accepting collaterals such as high-quality AAA-rated paper for conducting repos can be explored. However, further institutional progress in the form of better transparency and delivery and settlement procedures in respect of the corporate bond market is also necessary before this could be considered[106].

[106] The Reserve Bank provided some flexibility in the use of SLR securities for LAF effective September 17, 2008 on a temporary basis.

Furthermore, a reduction in statutory pre-emption of SLR below 25[107] per cent could be considered while taking account of the SLR requirement as a prudential instrument. It needs to be mentioned that, internationally, central bank collateral policies have come under pressure since the 2007-08 financial market crisis[108]. Though there are benefits to socialising a part of the cost through central bank liquidity management and back-up liquidity facilities, since liquidity carries a cost, it is important that market participants have an incentive to recognise and bear some of the cost, through the way their portfolios are structured. As was observed in the Fed's bail-out of Bear Stearns and AIG, further work is needed in the pricing and collateral selection of emergency facilities, whether targeted at pressures facing an individual institution or, more particularly, pressures facing the markets more widely, in such a way that they can be used as intended, while motivating the market to revert to normal funding channels as soon as possible. Hence, the CFSA is of the view that this issue needs further detailed discussion before introducing additional measures.

Internationally central bank collateral policies have come under pressure since the financial crisis.

In this context, the Panel also felt that there is a case for moving towards a narrower corridor for overnight money market rates and an eventual shift to a single overnight target rate along the lines of the Fed funds target rate in the US. If some banks continue to take recourse to this window persistently, a supervisory review process needs to be initiated.

Market participants should bear some costs of liquidity management during times of excess/ shortage of liquidity.

The CFSA endorses the suggestions for improving cash and liquidity management and strengthening skills in forecasting. However, as regards the corridor for overnight money markets, it is of the opinion that the Reserve Bank has to constantly look at monetary operations so that the integrity of the corridor for overnight money market can be sustained. A narrow or broad corridor at any time is the result of circumstances.

### 5.3.3 Issues Related to CRR

In recent times, CRR has been increasingly used as a tool to modulate credit growth and as an instrument of monetary management. The payment of interest on CRR results in attenuation of monetary control, since interest payments lead to infusion of further liquidity in the second round. After the amendment to the RBI Act in 2006, the Reserve Bank is barred from paying interest on banks' CRR balances. The Panel on Financial Stability Assessment and Stress Testing observed that in a market-oriented financial system, a high CRR (which was at 9 per cent as on August 30, 2008), when unremunerated, causes distortion in the term structure of interest rates. However, the quantum of the impact on a bank's balance sheet depends on several factors, particularly on the vibrancy of the money market and the ability of the bank to pass the burden on to customers. The CFSA notes that the CRR has been increased in recent years to contain liquidity generated by foreign exchange

The Reserve Bank has to constantly look at monetary operations so that the integrity of the corridor for the overnight money market can be sustained.

[107] Reduced to 24 per cent.
[108] IMG Working Paper - Central Bank Collateral Frameworks: Principles and Policies – September 2008.

operations and control inflation expectations and that its use largely depends on the prevailing monetary, macro and liquidity conditions in the economy. This is borne out by the fact that during September 2004 to August 2008, CRR, as an instrument of monetary management, was increased in phases by 400 basis points and subsequently, on a review of liquidity conditions, was reduced by 400 basis points by January, 2009. The CFSA would like to reiterate that the Reserve Bank's medium-term goal of bringing down the CRR to a low minimum should remain intact.

**5.3.4 Introduction of a Term Liquidity Facility**

In the absence of any short-term liquidity window from the central bank, in a range of about 15 days to 3 months, banks find it difficult to lend short-term when they perceive liquidity tightness due to tax outflows and large government borrowings. These instances were particularly apparent in January 2007, March 2007, April 2007, July 2007 and January 2008. As a result, there have been instances where the liquidity at the short end dried up, causing call rates and short-term deposit rates to witness steep hikes, even under overall benign liquidity conditions. The Panel on Financial Stability Assessment and Stress Testing considered these issues and concluded that the present LAF alone does not adequately address the liquidity needs of the banking system in periods of market tightness. While the central bank has been absorbing liquidity through OMO, MSS and CRR on a term basis, there is no window available to provide liquidity to the market on term basis except through emergency lending, which the banks can access only in times of deep distress. An appropriately designed term liquidity facility can provide powerful incentives to develop the term money market.

The Panel, therefore, felt that there is a need for opening a term liquidity window subject to the usual prudential safeguards. While this has been seconded by Mr. Sundararajan, one of the peer reviewers for the Panel Report, the other peer reviewer, Mr. Andrew Sheng, was not in favour of the provision of term liquidity being with the central bank as it has the potential to transform the functions of the Reserve Bank to the lender of first and not last resort. He felt that instead there should be a mechanism for issuance of treasury paper for market development and to fund short-term liquidity requirements. The Panel, however, felt that Mr. Sheng's suggestion may violate the spirit of FRBM[109].

Reserve Bank's medium term goal of bringing down CRR to a low minimum should remain intact.

[109] The Fiscal Responsibility and Budget Management Act was enacted by Parliament in 2003 to bring in fiscal discipline. The FRBM Rules impose limits on fiscal and revenue deficit, which are to be brought down in a phased manner.

In this context, the Panel recommended reintroduction of a general refinance facility against loan assets and government securities to commercial banks, subject to limits and at a spread of about 100 bps above the repo rate as a term liquidity facility. This facility could continue as an interim measure, until the CRR remains above 3 per cent and SLR, say, above 20 per cent. The Panel believed that while this facility may not be used by banks in the normal course, in times of tightness caused by skewed supply conditions this will enable better distribution of available liquidity in the market, thus easing pressure on interest rates. Second, banks should have the freedom to operate two-way in the short-term money market as in the case of government securities and foreign exchange markets, so that they can freely lend and borrow in the money market, including the call money market. This will enable surplus and deficit units to flexibly reach a market clearing situation. This facility should ideally be operative at the initiative of the Reserve Bank, for such periods, based on forecasts of the size and durability of bank reserve variations.

The CFSA feels that currently the Reserve Bank has a number of instruments whereby it can manage liquidity, such as OMO and LAF, and, if need be, by adjusting SLR. Besides, LAF term can be extended in times of need. A measure like the term liquidity facility in countries like the US has been necessitated by abnormal market conditions. Furthermore, such a facility would widen the interest rate corridor in the short-term money market. There was also a difference of view between the two peer reviewers in this regard. The CFSA is not in favour of introducing a term liquidity facility as the existing instruments are adequate to address seasonalities and short-term uncertainties in liquidity conditions that cause volatility in overnight rates.

### 5.3.5 Conventional Role of the Reserve Bank as LoLR

Recent events like the sub-prime crisis and the treatment of Northern Rock in the UK and Bear Sterns and AIG in the US have highlighted the need for more careful management of liquidity risk. Though the existing provisions in the RBI Act[110] empower the Reserve Bank to provide liquidity in times of crisis, the Panel on Financial Regulation and Supervision felt that given the increasing integration of global markets as also innovations that are taking place, the present crisis has necessitated the need for a re-look at the conventional role of Lender of Last Resort (LoLR). Accordingly, it recommended that the Reserve Bank consider constituting a Working Group to look into issues relating to liquidity with a specific mandate to examine: (i) the powers available as per extant provisions with the Reserve Bank as regards its role of LoLR; (ii) the scope for putting in place a mechanism, whereby the

The CFSA is not in favour of introducing a term liquidity facility, as the existing instruments are adequate.

[110] Section 17 of the RBI Act empowers the Reserve Bank to grant advance to scheduled banks by rediscounting the bills of exchange as also granting advance to various entities as notified by the Central Government. Further, Section 18 of the RBI Act empowers the Reserve Bank to purchase, sell or discount any bill of exchange or promissory note though the same may not be entitled for purchase or discount and also make loans or advances to any entity in the case of a special occasion.

same can be activated at the shortest possible notice; and (iii) the scope for expanding the instruments that can be permitted for providing liquidity.

The CFSA notes that, internationally, central banks need to distinguish between institutions whose liquidity pressures stem primarily from a breakdown in financial market functioning and those whose problems derive from underlying concerns about their solvency. The choice of tools in a crisis should depend on the circumstances as well as on specific institutional factors. Also, often, the efficacy of a regular discount window has been limited by the reluctance of institutions to use the window as a source of funding. The 'stigma' associated with the discount window, which intensifies during periods of crisis, arises primarily from banks' concerns that market participants will draw adverse inferences about their financial condition if their frequent recourse to borrowing from the central bank were to become public.

The CFSA, therefore, feels that while the views of the Panel have merits, it would not encourage a system of providing, *ex-ante*, any assurance about the Reserve Bank's emergency support. That would be a source of moral hazard. The CFSA recognises that currently the Reserve Bank has enormous powers and a variety of instruments to meet crisis situations. The Reserve Bank's interventions should depend on specific circumstances and judgement about contagion and systemic stability. But it would not be pragmatic to lay down *ex-ante* the extent and circumstances under which it would play its role of LoLR. Furthermore, the Reserve Bank has at present the choice of using conventional and unconventional measures as needed. Any blueprint for LoLR will constrain the Reserve Bank from using unconventional measures in times of extreme market distress as many central banks did to bail out afflicted market firms in the current crisis.

#### 5.3.6 Impact of Capital Inflows

In emerging markets, capital flows are often perceived to be relatively more volatile and sentiment-driven, not necessarily being related to the fundamentals in these markets. Such volatility imposes substantial risks on market agents, which they may not be able to sustain or manage. The appropriate management of monetary policy may require the monetary authorities to consider offsetting the impact of such capital flows through foreign exchange market intervention, either partly or wholly, so as to retain the intent of monetary policy through such intervention. The key issue under consideration of the monetary authority is to determine whether the capital

The CFSA would not encourage a system of providing, *ex-ante*, any assurance about the Reserve Bank's emergency support.

inflows are of a permanent and sustainable nature or temporary and subject to 'sudden stops' and reversal[111]. It also needs to be recognised that India exhibits twin deficits and the capital inflows far exceed the financing needs of the current account.

Swings in capital inflows without offsetting changes in the current account balances can lead to large and possibly disruptive changes in exchange rate. Large capital inflows, whether absorbed or not, can create asset bubbles and can be disruptive to EMEs. Inflows of foreign currency have had major consequences for the liquidity of the domestic financial system. The price stability focus of monetary policy can be undermined by paying too much attention to exchange rate objectives[112].

The Panel on Financial Stability Assessment and Stress Testing observed that while larger capital inflows result in greater comfort due to build up of reserves, it could also usher in volatility in currency movements. Quite often, the Reserve Bank's intervention has resulted in an immediate expansion in primary money with attendant consequences for maintaining price stability. In this context, it is important to recognise whether capital flows are of an enduring or temporary nature. The financial year 2008-09 have seen a significant outflow of capital due to abrupt changes in sentiments and adverse global liquidity conditions. There is a need to examine the likely implications of excessive inflows and outflows on monetary operations. Strategic management of the capital account would warrant preparedness for all situations.

### 5.3.7 Policy Responses to Shocks of Financial Turmoil

The recent sub-prime turmoil caused the shocks of reversal in capital flows combined with increase in spreads. Until 1997, Latin America was the region most prone to large-scale capital inflow reversal. During the Asian crisis of 1997, several countries, notably Thailand, suffered from large reversals leading to large outflows. This led to reserve losses and marked reduction in growth momentum accompanied by financial instability, especially in the banking sector. Banking sector crises have been inevitably preceded by sudden stops of capital flows leading to deleterious effects on output, import, bank deposits, and asset prices, which have taken longer to recover from than in a purely currency crisis (Calvo and Reinhart, 1998). Strengthening the external sector and banking and financial system soundness in the countries and making the system more resilient to direct shocks have become the cornerstone of macroeconomic policy since then.

The key issue is to determine whether the capital inflows are of a permanent and sustainable nature or temporary and subject to 'sudden stops' and reversal.

Following the financial sector reforms since the early 1990s and thanks to prudent macroeconomic management, and the impact of the global financial turmoil in India has been lesser than many other countries for a

[111] 'Sudden stop' is defined as a large and unanticipated fall in capital inflows, particularly in the context of emerging market economies (Calvo, 2008).

[112] Source: Draft Report on Capital flows and emerging market economies – BIS Committee on Global Financial Systems.

variety of reasons: its capital account is not fully open; the exposure of the financial sector, particularly the banking sector, to sub-prime mortgage assets, direct or indirect, was low; the credit derivatives market in India is small and has better elements of prudential safeguards; and the banking system predominantly owned by the public sector remained sound and resilient. However, due to the greater integration of financial markets and external trade and current accounts, India has faced the challenge of managing liquidity – both of the rupee and foreign exchange – as a consequence of temporary cessation/reversal of capital flows since mid-September, 2008.

The reversal of capital flows is evident from net outflows of FII investments, difficulties in refinancing of ECBs and availment of trade credit, even while the FDI flows remained very buoyant in the current year. This had two effects, viz., first, the equity market took a hit and consequently mutual funds faced redemption pressure. The BSE Sensex and Nifty have come down by more than 50 per cent, and money market mutual funds (MMMFs) have been affected. With domestic liquidity drying up, the problems faced by MMMFs became more acute.

The cessation/reversal of capital flows had also impacted the exchange rate and the rupee depreciated. Since the Reserve Bank actively intervenes in the foreign exchange market to contain exchange rate volatility, the dollar sales impacted the rupee liquidity in the system causing further pressure on the banking system.

Concomitantly, the reversal of capital flows also affected domestic liquidity because the corporates who were relying on overseas borrowings faced problems raising funds abroad, besides facing sharp increases in spreads. This resulted in excess demand for domestic liquidity. This meant more banks approaching the Reserve Bank for repo, causing pressure on the LAF window.

In the above circumstances, the additional demand for domestic liquidity can be met by the Reserve Bank through a cut in CRR, LAF injections, winding down or MSS buyback, and by providing general or sector specific refinance facilities. Since banks can utilise only excess SLR securities for operating in the LAF window, a reduction in SLR could also help improve domestic liquidity conditions enabling more flexible operation of the LAF/ OMO window of the Reserve Bank and a more active inter-bank repo market.

In a nutshell, the adverse impact on domestic rupee liquidity due to the reversal of capital flows can be countered by the Reserve Bank substituting net

foreign exchange assets as a source of reserve money with net domestic assets in its balance sheet, so that the domestic primary liquidity is sustained adequately to meet the credit needs of the economy, consistent with growth prospects. The leeway available to the Reserve Bank to undertake appropriate policy and operations in the above regard, however, will depend upon the monetary and credit projections. The need for additional liquidity should be viewed in the light of potential inflationary pressures that it could create, if actual liquidity injection becomes excessive. The Reserve Bank has taken a series of measures since mid-September in the above direction.

The Reserve Bank has taken a series of measures to counter the liquidity impact of global financial crisis.

**5.3.8 Unhedged Open Position of Corporates**

The Panel on Financial Stability Assessment and Stress Testing was of the view that market perception at times resulted in proliferation of businesses, which do not have a natural currency hedge, maintaining unhedged positions and not adopting prudent risk management practices, which could impact corporate profitability in case the exchange rate turns unfavourable. This is in spite of a fairly well-developed authorised dealer network offering products that could mitigate the exchange rate risks. The Panel felt that there is a need for market participants to employ better risk management practices. Banks need to strengthen their monitoring of the unhedged position of corporates, since the currency risk has the potential to transform into credit risk.

The CFSA is of the view that the day-to-day movements in exchange rates are market determined and the exchange rate management policies by the Reserve Bank are aimed at management of the exchange rate, meeting temporary supply-demand gaps which may arise due to uncertainties or other reasons, and curbing destabilising and self-fulfilling speculative activities. With these objectives in mind, the Reserve Bank intervention in the market ensures that excessive volatilities in the rupee-dollar rate are reduced. While hedging is a commercial decision, the impact of market risk-triggered credit risk on the financials of the banks could be significant. The banks, therefore, need to be aware of and monitor the unhedged corporate risk of their clients. Banks have been encouraged to obtain information from their large borrowers regarding the quantum of unhedged foreign currency exposure. In this context, the Panel on Financial Stability Assessment and Stress Testing felt that in the interests of market discipline, ICAI could mandate companies to disclose their unhedged foreign currency exposure as part of their Annual Reports. This could be supplemented by the Reserve Bank periodically collating and disclosing information related to unhedged open position of corporates obtained from authorised dealers (ADs). The CFSA feels that these recommendations are worthy of consideration by the ICAI. Further, it also feels that the Reserve Bank should consider requiring scheduled commercial banks to act on the recommendations of the Panel with immediate effect.

In the interests of market discipline, ICAI could mandate companies to disclose their unhedged foreign currency exposure as part of their Annual Reports.

**5.3.9 Global Imbalance**

Contrary to the perception of India being decoupled from the global economic conditions, it has been seen that the disorderly unwinding of global

imbalances, particularly in the current context of financial turmoil, has affected the Indian economy indirectly. The Panel on Financial Stability Assessment and Stress Testing felt that the significant risk arising from the sudden unwinding of position could be a source of risk to financial stability. Though the exposures of banks, corporates and households in India to the external sector are not very significant, there is a need to be alert to domestic and global shocks and pro-actively manage the risks. The CFSA feels that while various pre-emptive measures have already been taken to maintain credit quality and sustain the growth momentum, there is a need to be vigilant and remain in a state of constant preparedness for any crises which may occur through disorderly unwinding of global imbalance.

**5.3.10 Financial Integrity**

Money laundering activities adversely affect the financial sector, the real sector and the external sector of an economy. Association with money laundering, even advertently, tends to expose financial sector institutions to the risk of inevitably undermining public confidence in these institutions. Lack of public confidence in such institutions would prevent their further development. Loss of confidence in a country's financial system would also deter Foreign Direct Investment (FDI) flows, as genuine investors would be reluctant to deal with financial institutions which are perceived to be contaminated with money laundering activities. When using a country's territory for money laundering activities, particularly in the layering stage, money launderers tend to bring large amounts of money into the country and then exit to another jurisdiction. This results in the liability base of financial institutions becoming unstable and causes an upsurge of activity in the financial sector followed by a downturn which could, in turn, contribute to financial sector instability. Further, overseas banks may be reluctant to have correspondence relationships with banks which are tainted by money laundering allegations, adversely affecting banking activity in various spheres. Hence, both conceptually and in practice, restrictions on suspicious flows enhance the reputation of markets and lead to healthy flows.

Restrictions on suspicious flows enhance the reputation of markets and lead to healthy flows

Consistent with the principle of a hierarchy of capital flows, India has been making efforts towards encouraging more inflows through FDI and enhancing the quality of portfolio flows by strict adherence to the 'know your investor' principle. One concern in the context of market integrity which has been debated is the investment through the participatory note (PN) route by FIIs. The Government is of the opinion that as FIIs maintain records of identity of the entity they issue PNs to and SEBI can obtain this information

from the FIIs, there does not appear to be any cause of concern from the KYC angle. Further, PNs can be issued or transferred only to persons who are regulated by an appropriate foreign regulatory authority. The Reserve Bank's concern is that as PNs are tradable instruments overseas, this could lead to multi-layering which will make it difficult to identify the ultimate holders of PNs. Furthermore, the transactions of FIIs with the PNs are outside the real-time surveillance mechanism of SEBI.

**5.3.11 Summary**

Till the first half year 2008, large capital movements have necessitated the Reserve Bank to sterilise the excessive monetary impact of inflows. The total absorption of liquidity from the system by the Reserve Bank in line with the monetary policy stance from time to time gets reflected in the use of instruments of LAF, MSS and open market operations. There has been symmetric treatment of large capital outflows which was evidenced subsequently.

*Volatility in Overnight Rates*

The movement of overnight rates has often witnessed spikes at the end of each quarter due to advance tax payment and year-end considerations for banks. Volatility has been accentuated by the difficulties in estimation of cash flows with any reasonable degree of accuracy in government accounts, largely arising from difficulties in projecting the receipts and payments of Governments. There is, therefore, a need to strengthen the management of government cash balances. A working group has been constituted in the context of better cash management by the Government.

The overnight segment of the money market shows some volatility due to lack of liquidity. The management of overnight temporary liquidity is incidental on accurate liquidity forecasts, which currently is not very precise. There is also a need to refine the indicators of liquidity both for better monetary/credit management and to minimise systemic risk and financial crisis propagation.

*Limitation of LAF Operations*

The introduction of LAF has led to a passive role adopted by some banks in managing their day-to-day liquidity position, and also its operations are constrained by the availability of securities both with them and with the Reserve Bank. Market participants should bear some costs of liquidity management and market participants during times of excess/shortage of liquidity. Additional collaterals like high-quality AAA-rated paper for conducting repo may be explored. This would require further institutional progress in the form of better transparency and delivery and settlement procedures in respect of the corporate bond market.

Central bank collateral policies have come under pressure in dealing with the current financial market crisis. Though there are benefits in absorbing part of the cost through central bank liquidity management and

back-up liquidity facilities, since liquidity carries a cost, it is important that market participants have an incentive to recognise and bear some of the cost through the way their portfolios are structured. This issue needs further detailed discussion before introducing additional measures.

As regards the corridor for overnight money markets, a narrow or a broad corridor at any time is the result of circumstances.

*Issues related to CRR*

In recent times, CRR has been increasingly used as a tool to modulate growth in credit and monetary aggregates in order to contain inflation expectations. The Reserve Bank is refrained from paying interest on banks' CRR balances. It also is reiterated that the Reserve Bank's medium-term goal of bringing down the CRR to a low minimum should remain intact, as also stated by the Reserve Bank.

*Introduction of a Term Liquidity Facility*

In the absence of any short-term liquidity window from the central bank, in a range of about 15 days to 3 months, banks find it difficult to lend short-term. The present LAF alone does not adequately address the liquidity needs of the banking system in periods of market tightness. An appropriately designed term liquidity facility can provide powerful incentives to develop the term money market. Reintroduction of a general refinance facility against loan assets and government securities to commercial banks has been recommended. The CFSA observes that currently the Reserve Bank has a number of instruments for liquidity management, like OMO and LAF and, if need be, it can be done by adjusting SLR. Such a term liquidity facility currently is extended in countries like the US in the context of the financial crisis. Such facilities under normal market conditions would make the central bank a lender of first resort and not last resort.

*Conventional role of the Reserve Bank as LoLR*

Recent events following the sub-prime crisis like the treatment of Northern Rock in the UK and Bear Sterns and AIG in the US have highlighted the need for more careful management of liquidity risk. Central banks need to distinguish between institutions whose liquidity pressures stem primarily from a breakdown in financial market functioning and those whose problems fundamentally derive from underlying concerns about their solvency. The Reserve Bank's interventions should depend upon specific circumstances and judgment about contagion and systemic stability.

*Impact of Capital Inflows*

In emerging markets, capital flows are often relatively more volatile and sentiment-driven and not necessarily related to the fundamentals in these markets. The key issue for the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or temporary and subject to 'sudden stops' and reversal. Strategic management of the capital account would warrant preparedness for all situations

*Policy Responses to Shocks of Sub-prime Turmoil*

The recent global financial crisis caused the shocks of reversal in capital flows combined with increase in spreads. prudent macroeconomic management coupled with a gradualist approach to financial sector reforms has resulted in India being impacted to a lesser extent by current financial turmoil. The financial sector reforms initiated by India since 1990s insulated it to great extent from the present crisis. However, due to greater integration of financial markets and external trade and current accounts, India faced the challenge of managing liquidity – both of the rupee and foreign exchange – as a consequence of cessation/reversal of capital flows since mid-September 2008. The additional demand for domestic liquidity in the above circumstances can be met by the Reserve Bank through a cut in CRR, LAF injections, winding down or MSS buy-back and by providing general or sector-specific refinance facilities. Since banks can utilise only excess SLR securities for operating in the LAF window, a reduction in SLR could also help improve domestic liquidity conditions, enabling more flexible operation of the LAF/OMO window of the Reserve Bank and a more active inter-bank repo market.

The adverse impact on domestic rupee liquidity due to reversal of capital flows can be countered by the Reserve Bank substituting loss in net foreign exchange assets as a source of reserve money with net domestic assets in the balance sheet, so that domestic liquidity is sustained adequately to meet the credit needs of the economy, consistent with growth prospects. This can be undertaken by the Reserve Bank, depending on monetary and credit projections. The need for additional liquidity should be viewed in light of potential inflationary pressures that it could create, if actual liquidity injection becomes excessive. The measures have been taken by the Reserve Bank since mid-September that need to be viewed in the above direction.

*Unhedged Open Position of Corporates*

Monitoring of unhedged position of corporates by banks needs to be strengthened, since the currency risk has the potential to transform into credit risk. There is a need for market participants to employ better risk management practices. In the interests of market discipline, ICAI could mandate companies to disclose their unhedged foreign currency exposure as a part of their Annual Reports. This could be supplemented by the Reserve Bank periodically collating and disclosing the information related to disclosures of unhedged currency position obtained from ADs. RBI should

consider requiring SCBs to act on the recommendations of the Panel with immediate effect.

*Global Imbalance*

Though India is, by and large, is relatively less affected at present from the consequences of global imbalance, any disorderly unwinding of global imbalances, particularly in the current context of financial turmoil, is likely to have global ramifications that may affect the Indian economy indirectly. While various pre-emptive measures have been taken to maintain credit quality and sustain the growth momentum, there is a need to be vigilant and remain in a state of constant preparedness for any crisis which may occur through disorderly unwinding of global imbalances.

*Financial Integrity*

Association with money laundering, even inadvertently, tends to expose financial sector institutions to the risk of inevitably undermining public confidence in these institutions. and also deter Foreign Direct Investment (FDI) flows. Consistent with the principle of hierarchy of capital flows, India has been making efforts towards encouraging more inflows through FDI and enhancing the quality of portfolio flows by strict adherence to the 'know your investor' principle. Given the growing concern about the origin and source of investment funds flowing into the country, there is a need to take suitable measures which would enhance the confidence of foreign investors and regulators in the Indian financial system.

One concern in the context of market integrity is investment through the participatory note route by FIIs. The Government is of the opinion that since FIIs maintain records of the identity of the entity they issue PNs to and SEBI can obtain this information from FIIs, there does not appear to be any cause for concern from the KYC angle. Further, PNs can be issued or transferred only to persons who are regulated by an appropriate foreign regulatory authority. The Reserve Bank's concern is that as PNs are tradable instruments overseas, this could lead to multi-layering which will make it difficult to identify the ultimate holders of PNs. Furthermore, the transactions of FIIs with the PNs are outside the real-time surveillance mechanism of SEBI.

## 5.4 Accounting Standards

### 5.4.1 Benchmark

The benchmark used for assessment of Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) is International

Accounting Standards. The International Accounting Standards Committee (IASC) was constituted in 1973 for harmonising global accounting policies and practices and has developed the International Accounting Standards (IASs). IASC issued 41 standards until 2001 when a process of reconstitution was undertaken and the role of development of International Accounting Standards was transferred to the International Accounting Standards Board (IASB). Consequent to reconstitution in April 2001, the IASB took over the responsibility of setting accounting standards. The standards issued by the IASB are known as International Financial Reporting Standards (IFRS). Since 2001, new IFRSs have been issued, many IASs have been revised and certain IASs have been withdrawn by the IASB. As and when IASs are completely revised, they are issued as IFRSs. As of date, 29 IASs are in force and the rest are withdrawn, with 8 IFRSs having been issued by IASB. IASs and IFRSs are collectively referred to as IFRSs. Apart from IFRSs, there is one more accounting standard which has been widely used and is referred to as US Generally Accepted Accounting Principles (GAAP).

### 5.4.2 Earlier Assessments

The Reserve Bank, in 2000, constituted an Advisory Group to evaluate and report on observance of international standards and codes in accounting and auditing in India. The Group compared the Indian accounting and auditing standards with international standards, identified gaps and made recommendations to bridge the gaps. It observed that there is a significant gap between standards issued by IASC and ICAI, especially in respect of standards relating to financial institutions. All standards issued by ICAI do not correspond to the standards issued by IASC. It recommended that steps be taken to reduce the gaps between Indian and International Accounting Standards. It also recommended that the Accounting Standards Board (ASB) should be an autonomous body within ICAI, with its own staff and independent funding. There should be only one standard-setting authority in the country. ASB should set up a separate committee to address issues requiring immediate pronouncements. There should be a mechanism in place to monitor compliance with standards.

Subsequent to this, the Report on Observance of Standards and Codes (ROSC), brought out by the World Bank in 2004, observed that though Indian accounting standards were developed on the basis of international standards, there was room for improvement. The Report recommended, among other things, that steps need to be taken to issue national standards for IFRSs for which equivalent national standards are not yet issued. There was a need for rationalisation of the Companies Act, specifically Schedule VI and the rates of depreciation, to bring it in line with accounting standards. ICAI needed to be recognised as single accounting standard-setting body. There was a need to bring regulations and monitoring of financial reporting practice by all corporate banks under the purview of the Reserve Bank.

### 5.4.3 Assessment and Recommendations by the Advisory Panel on Institutions and Market Structure

The Advisory Panel on Institutions and Market Structure observed that the process of codification of Accounting Standards by the Indian Accounting Standards Board began with the establishment of ICAI in 1977 and the attempt from the beginning has been to have harmony with the International Accounting Standards, keeping in mind the local customs, usages, level of development and environment in the country. Accounting standards in India got legal basis consequent to the insertion of Section 211(3A), (3B) and (3C) in the Companies Act, 1956 which made it mandatory for all companies to prepare their accounts in accordance with standards recommended by ICAI and prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS)[113]. It also noted that there are a total of 31 Indian Accounting Standards which have been issued by ICAI, apart from accounting standards for small and medium enterprises, not-for-profit organisations, local bodies, Governments and business enterprises that are governed by specific Acts of Parliament. It also acknowledged that there are various mechanisms in place for enforcement of the accounting standards in the Companies Act, Listing Agreements, disciplinary action by ICAI, Financial Reporting Review Board[114], Peer Review Board[115] and Quality Review Board[116].

The Panel noted that though there have been many significant developments since the last ROSC of 2004, there are still some gaps *vis-à-vis* International Accounting Standards which need to be plugged. Accordingly the Panel has tried to address issues regarding the convergence of Indian Accounting Standards with IFRSs, developing sector-specific guidance, authority for issuance of standards and training of professionals. The CFSA is generally in agreement with the assessment and recommendations of the Advisory Panel with regard to the aforesaid areas.

There are still some gaps *vis-à-vis* International Accounting Standards which need to be plugged.

[113] Section 210A of the Companies Act provides for composition of NACAS.

[114] ICAI has established the Financial Reporting Review Board which reviews financial statements from a compliance perspective and recommends appropriate action to the Ministry of Corporate Affairs, SEBI and other regulators.

[115] The Peer Review Board established by ICAI in April 2002 aims at improving/enhancing the quality of service performed by members of ICAI, especially in relation to compliance with the technical standards by a firm (Practice Unit).

[116] Though not directly concerned with the enforcement of Accounting Standards, the newly-constituted Quality Review Board, following issuance of Notification by Government in June 2007, will also have a persuasive influence and will encourage the reporting of non-compliance with Accounting Standards.

The CFSA, however, would like to note that the recent sub-prime crisis has highlighted weaknesses in the application of accounting standards and the shortcomings associated with the valuation and financial reporting of structured products that played a significant role in the current turbulence through pro-cyclical valuations and lack of full disclosure of banks' true risk profile through the cycle. The proposals by the Financial Stability Forum, *inter alia,* have recommended steps to bridge these gaps. In this light, the CFSA feels that there is a need to collectively review and resolve, among other things, the accounting rules and the approach of the authorities that tend to apply these rules. Further, problems relating to recent derivatives transactions in India, wherein banks and corporates are involved in law-suits, have brought to the fore the necessity for early adoption of accounting standards AS 30 and 31 relating to financial instruments. It may be added that some of the issues relating to accounting standards have been covered as part of the assessment of Basel Core Principles with reference to financial institutions and IOSCO principles with reference to financial markets.

There is a need to collectively review and resolve the accounting rules and the approach of the authorities that tend to apply these rules.

The Report was peer reviewed by Mr. Ian Mackintosh, Chairman, Accounting Standards Board, UK and Dr. Kamal Gupta. Mr. Mackintosh has commented on the country-specific standards, sector-specific guidance and interpretations, role of the standard-setter, importance of training and the influence that the standard-setter in India would have over IASB, both in its agenda and in its technical output. Dr. Gupta has commented on the classification of enterprises at three levels and convergence with IFRSs. The recommendations given by the Panel have been consolidated and presented under appropriate heads.

*Authority for Development and Issuance of Standards*

The Panel notes that though ASB, as a committee of ICAI, has representation from outside the ICAI Council, it is not truly autonomous. It agrees that as the Accounting Standards issued by the Council of ICAI are only recommendatory and have to be prescribed by the Central Government in consultation with NACAS, this lends some degree of outside review to the standards. However, it feels that the autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and the Council of ICAI confines itself to the administrative, but not the functional, control of the ASB. Further, it feels that there is a need for codifying the constitution of ASB as this will add to the transparency of the process adopted by ICAI.

The autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and the Council of ICAI confines itself to the administrative, but not the functional, control.

The Panel notes that IASB has been coming out with new standards over a period of time. However, it feels that there may be instances where India finds that there is no international accounting standard on a subject of importance for the country and there is imminent need to have a standard on the subject. The peer reviewer, Mr. Mackintosh, had advised the exercise of caution while developing country-specific and sector-specific standards. The preferred solution is to get the IASB to act on the matter and to provide an international solution for national application. He felt that country-specific

matters would be rare. Likewise, he felt that sector-specific standards are not something to be precluded entirely, but to be handled with great care. Taking due account of the caution, the Panel felt that there is a need for the ASB to consider the development of standards on such subjects if the work program of IASB does not permit taking up development of standards on that subject. However, it added that such standard(s) ought to be replaced by the international standard, as and when issued by the IASB, to have convergence with international standards. In addition, it felt that as the accounting standards issued by ICAI are general purpose accounting standards, it needed to consider providing sector-specific guidance in application of these standards, *e.g.*, to banks and insurance companies. However, ICAI should ensure that this does not lead to the establishment of new principles.

The Panel noted that the accounting standards need to be reviewed with the changing times and this review could lead to issuance of an interpretation or a limited revision or complete revision of the standard. The Panel noted that, at present, the interpretations ought to be referred to the International Financial Reporting Interpretations Committee (IFRIC)[117]. The peer reviewer, Mr. Mackintosh, had suggested that interpretations should generally be referred to IFRIC and only in very rare circumstances of a purely Indian issue should the standard-setter be involved. On this basis, the Panel recommends that, in the interim period, ICAI may issue an interpretation on a need basis for which it should constitute an independent Interpretation Committee. Further, it adds that the interpretations issued by India may require to be modified if interpretations, as and when issued by IFRIC, are different from the ones issued by ICAI.

Though accounting standards issued by ICAI are applicable to all entities, given the legal backing it has got consequent to the insertion of Section 211(3A), (3B) and (3C) in the Companies Act, there is a need for scheduled co-operative banks to adopt the same standards/accounting principles as applicable to commercial banks. The Panel feels that the Government, in consultation with the Reserve Bank, needs to take necessary steps in this regard. It adds that as regards the large non-scheduled co-operative banks, the same standards need to be adopted by them gradually and a time-bound programme should be drawn up in this regard. However, as regards smaller co-operative banks, the Panel feels that they may be given some concessions in application of accounting principles, just as concessions

[117] The interpretations of IASs and IFRSs are developed by the International Financial Reporting Interpretations Committee (IFRIC).

are given to small and medium-sized enterprises. Thus, there is a need to give more time to these entities, but a time-bound implementation programme needs to be drawn up at the earliest.

*Convergence with IFRSs and Participation in International Standard-setting Process*

The Panel noted that given the fact that 105 countries in the world have adopted IFRSs, as also the endeavour being made by ICAI to have convergence with IFRSs, steps need to be taken to have convergence at the earliest. It noted that ICAI has decided that IFRSs would be recommendatory at least in respect of listed entities and other public interest entities from April 1, 2009 and mandatory from April 1, 2011. The Panel desires that awareness should be created about IFRSs among auditors and all others who are involved in the process, as also to ensure that they are able to put in place systems and procedures to comply with IFRSs. The CFSA notes that the issue of convergence is even more important given that a number of entities are trying to spread their wings across borders and that several entities are trying to deal in complex products offered in the market. Hence, it is desirable that Indian accounting standards converge with international accounting standards. The CFSA notes that the Reserve Bank is in the process of preparing prudential guidelines for alignment of Indian accounting standards with international accounting standards, including investments and hedge accounting.

Given that India has been a member of the International Federation of Accountants since its inception and is now also a member of IASB, the Panel feels that once there is a convergence of Indian Accounting Standards with IFRSs, India should also contribute significantly in the agenda-setting of IASB and its technical output. Mr. Mackintosh also saw this as a major role for the ASB. In this endeavour, ICAI could constitute a group of academicians and professionals which could be more pro-active in suggesting items for the agenda of IASB and IFRIC as also for consideration of exposure drafts issued by these bodies.

The Panel notes that the Accounting Standards Board of ICAI is a broad-based body and has representatives from industry, Government departments and regulatory authorities, and representatives from academic and professional institutions. However, it feels that it should be ICAI's endeavour to hold continuous dialogues with regulatory bodies and take early action for the formulation or implementation of standards in developing areas and also work with such agencies to bring about changes in policy or legal provisions leading to robust accounting, disclosure and presentation norms and to remove disparities, if any, between legal provisions, policies and recommended accounting treatment.

It is desirable that Indian accounting standards converge with international accounting standards.

*Compliance Monitoring Programme, Guidance and Training Programmes*

ICAI had established the Financial Reporting Review Board, which reviews financial statements from the compliance perspective and recommends appropriate action to the Ministry of Corporate Affairs, SEBI and

other regulators. It also notes that there are systems in place, whereby the assessment of compliance to Accounting Standards in respect of banks/financial institutions and insurance companies is done by the Reserve Bank and IRDA, respectively. However, the Panel recommends that as and when there are interpretational issues in respect of any standards or in matters where there are no standards, the concerned regulator should take up such issues with ICAI on an ongoing basis.

The Panel notes that ICAI has been conducting training programs, on an ongoing basis, for its members and also for accountants in the industry. It recommends that it should continue to do so and take steps to enhance and broaden the scope, possibly with regulators (to enhance resource availability), and to impart more formalised training to preparers of financial statements. Further, given the inherent complexities that are coming up in new accounting standards, ICAI needs to increase the scope and frequency of its training programmes on the implementation of accounting standards. ICAI may also conduct special programs to educate members on IFRSs and their applications as also the US GAAP to provide a broader outlook to members. The peer reviewer, Mr. Mackintosh, was generally in agreement with the recommendations on monitoring and training, but suggested that care needs to be taken that the ICAI is not seen as interpreting the standards. While advice can be given on general principles, the accounting treatment will depend on the nature of the transaction involved and professional judgement will be required.

The Panel also suggests that ICAI can consider focusing more on practical aspects of the application of accounting standards as some of the standards that are of recent origin may require more guidance in implementation. The Panel recommends that ICAI may consider establishing informal mechanisms where members implementing standards could approach it.

ICAI needs to increase the scope and frequency of its training programmes on the implementation of accounting standards.

**5.4.4 Summary**

IASC, constituted in 1973, developed 41 standards until 2001. Consequent to its reconstitution in April 2001 as IASB, the latter took over the responsibility of setting Accounting Standards and the standards issued by the IASB are known as IFRS. As of date, 29 IASs are in force and the rest have been withdrawn, with 8 IFRSs having been issued by IASB. The process of codification of Indian Accounting Standards by the Accounting Standards Board (ASB) began with the establishment of ICAI in 1977. ICAI has issued a

total of 31 Indian Accounting Standards to date. There are gaps in areas relating to the convergence of Indian Accounting Standards with IFRSs, developing sector-specific guidance, authority for issuance of standards and training of professionals. The recent sub-prime crisis has also highlighted weaknesses in the application of accounting standards. Further, problems relating to recent derivatives transactions in India, wherein banks and corporates are involved in law-suits, have brought to the fore the necessity for early adoption of Accounting Standards AS 30 and 31 relating to financial instruments. The important recommendations of the Panel are:

(i) The autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and the Council of ICAI confines itself to the administrative, but not functional, control of the ASB.

(ii) There is a need for the ASB to consider the development of standard on certain subjects as also to provide sector-specific guidance in application of these standards, *e.g.*, to banks and insurance companies. ICAI may issue an interpretation on a need basis, for which it should constitute an independent Interpretation Committee.

(iii) Awareness should be created about IFRSs among auditors and all others involved in the process.

(iv) Once there is a convergence of Indian Accounting Standards with IFRSs, India should also contribute significantly in the agenda-setting of IASB and its technical output.

(v) ICAI should continue to conduct training programs and take steps to enhance and broaden the scope, possibly with regulators (to enhance resource availability), and to impart more formalised training to preparers of financial statements.

## 5.5 Auditing Standards

### 5.5.1 Benchmark

The International Auditing Practices Committee (IAPC) was constituted in October 1977 with the prime objective of enhancing the quality of and uniformity in auditing practices throughout the world and strengthening public confidence in the global auditing and assurance profession. Towards this end, the IAPC, which was renamed the International Auditing and Assurance Standards Board (IAASB) in 2002, is entrusted with the task of developing standards on auditing and review of historical financial information as also standards on other types of assurance engagement carried out in the context of information other than historical financial information. The IAASB also develops related practice statements. The International Standards on Auditing (ISAs) are widely accepted in India following efforts by the Auditing and Assurance Standards Board (AASB) in India, and the assessment has, thus, been made regarding adherence of the Indian auditing profession to the ISAs.

Problems relating to recent derivatives transactions in India have brought to the fore the necessity for early adoption of Accounting Standards AS 30 and 31.

IAASB has, since the commencement of its Clarity Project in 2004, aimed at improving the clarity of IAASB's pronouncements, making the ISAs easy to understand and implement. Pursuant to its Clarity Project, the IAASB has not only changed its conventions to draft the standards but is also in the process of revising/redrafting its entire suite of standards and hopes to complete the project by the end of 2009.

### 5.5.2 Earlier Assessments

The Reserve Bank, in 2000, constituted an Advisory Group to evaluate and report on observance of international standards and codes in accounting and auditing in India. The Group felt that it may be necessary to establish a body along the lines of the Financial Reporting Review Panel – either within the ICAI or outside – to monitor compliance with accounting standards. The requirement in the Companies Act that departures from accounting standards must be disclosed in the financial statements and that the auditor must report whether accounting standards have been followed provides a mechanism for the identification of violations. It needs to be further provided that auditors have an obligation to report directly to the Panel all cases of violation.

Subsequently, the Report on Observance of Standards and Codes (ROSC) of the World Bank in 2004 made an assessment of adherence of auditing standards in India to international standards. It observed that Auditing and Assurance Standards (AASs) in India, generally replicate the ISAs, modifications being made to adapt to the local circumstances and there are fewer audit alternatives as compared to ISAs. It also found that there are no AASs corresponding to ISA 100, *Assurance Engagements*; ISA 501, *Audit Evidence – Additional Consideration for Specific Items*; ISA 720, *Other Information in Documents Containing Audited Financial Statements*; and ISA 910, *Engagements to Review Financial Statements.* There were differences in standards related to audit planning, management representations, audit sampling and quality control. The incoming auditor was unable to access the working papers of the outgoing auditor. There was no requirement for assessment of the professional competence of another auditor. The quality of audit practices differed significantly among audit firms. There was improper use of the expression 'subject to/except for' audit opinions in audit reports.

### 5.5.3 Assessment and Recommendations by the Advisory Panel on Institutions and Market Structure

The Advisory Panel noted that ICAI has been represented in the International Audit Practices Committee (IAPC) (now known as IAASB) during its early years spanning 1980-86 and has, thus, played a role in drafting international standards. It also notes that AASB (known as APC upto 2002)[118] has been participating in the meetings of National Auditing Standard-Setters, which comprises 10 countries including India, and is playing a constructive role and, among other things, is involved in sharing knowledge on matters affecting international convergence. It also notes that a total of 100 countries across the world have adopted the ISAs and India is one among them which adopts ISAs by making amendments subject to local laws, customs and usages. The Panel noted that ICAI has been taking steps to encourage compliance through continuing professional education, peer review boards, quality review boards and enforcing compliance through its disciplinary mechanism and FRRB.[119]

The Panel notes that consequent to the ROSC-2004, the AASB has taken a number of initiatives to bridge the gaps *vis-à-vis* international auditing standards; however, there were still some gaps which need to be plugged. Accordingly, it has made some recommendations in areas relating to convergence with ISAs, implementation of auditing standards, strengthening the peer review process, increasing access to working papers and independence of auditors.

The Advisory Panel Report on auditing was peer reviewed by Shri N P Sarda, Chairman, Deloitte Haskins & Sells and by Mr. Ian Mackintosh, Chairman, Accounting Standards Board, UK. Shri Sarda has commented on the independent oversight mechanism as also implementation of auditing standards. Mr. Mackintosh has given general comments and also agreed to Panel's observations on non-acceptance of qualified reports as also giving functional independence to AASB. The CFSA is generally in agreement with the assessment and recommendations of the Advisory Panel with regard to the aforesaid areas. The recommendations given by the Panel have been consolidated and presented under the appropriate heads.

*Convergence with ISAs*

The Panel acknowledged that there are difficulties in convergence with ISAs inasmuch as it could lead to an increase in costs and higher fees that

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[118] Till 2002, the membership of APC comprised members of the Council of the Institute as well as co-opted members. In July 2002, to bring greater transparency and efficiency in the working of the APC, the Council of the Institute opened the meetings of the APC to regulators, industry representatives as well as academicians as special invitees.

[119] The Financial Reporting Review Board (FRRB) was constituted by the Council of the Institute of Chartered Accountants of India in July 2002, comprising members of the Council of the Institute (including a nominee of the Central Government on the Council) as well as representatives of the Insurance Regulatory and Development Authority and the Comptroller and Auditor General of India as special invitees. The primary function of the FRRB is to review the compliance, *inter alia*, with the reporting requirements of various applicable statutes, Accounting Standards and Auditing and Assurance Standards issued by the ICAI.

A strong message needs to be sent to practitioners that there is no option but to comply with the new requirements, by having a suitable deterrence mechanism in place.

need to be charged from clients. Nevertheless, it felt that AASB should strive for convergence with ISAs. Further, efforts need to be made at the Institute level as also at the practising firms to equip them with the new standards, especially when international standards are changing frequently. Efforts should also be made to issue Exposure Drafts by the AASB when they are issued by the IAASB.

*Implementation of Auditing Standards and Encouraging Compliance*

The Advisory Panel noted that there are a number of small and medium auditing practitioners in India. Given their limited resources and the difficulties they face in keeping pace with the changing audit literature, the Panel felt that the Institute needs to take pro-active steps by bringing out more technical guidance and other literature to help them understand new standards and aspects relating to their practical implementation. Moreover, this needs to be supplemented by organising training programmes, conferences and other such programmes on the new auditing literature and methodology. The Panel further added that merely taking pro-active steps and encouragement may not suffice; hence, a strong message needs to be sent to practitioners that there is no option but to comply with the new requirements, by having a suitable deterrence mechanism in place which could be ensured by strengthening the quality review and the disciplinary process.

There is need to keep a close watch on audits.

The Panel noted that the AASB has instituted the concept of peer review which aims at encouraging compliance with auditing standards. Further, it noted that the actual peer review in respect of a significant proportion of Stage I and Stage II Practice Units[120] remains to be completed, which needs to be examined to ensure the continuous efficacy of the process. However, there are Stage III units which comprise small and medium enterprises that should not be ignored. Hence, the Panel felt that there is need to keep a close watch on audits done by these Stage III units, as these audits are done mainly by small and medium audit firms, a segment of auditors which is typically plagued by issues such as inability to keep up with the technical pronouncements of the Institute on a regular basis, inadequate staff

[120] Stage I of the peer review process covered all practice units which carry out audits of enterprises involving large amounts of funds – Government/public (paid-up capital above Rs.5 crore and annual turnover of more than Rs.50 crore), central statutory auditor of banks, insurance companies, central co-operative societies, asset management companies, and mutual funds. Stage II covered firms carrying out audits of branches of public sector banks/private sector and foreign branches, regional rural banks, co-operative banks and NBFCs listed on stock exchanges and not covered in Stage I. Stage III covered the rest of the firms.

and failure to provide them with proper training and mentoring, and over-familiarity with/financial over-dependence on a few clients leading to potential independence threats. Though these are valid considerations, the Panel felt that, until the resources of ICAI are significantly enhanced, it may be desirable to give priority to Stage I and Stage II Practice Units where large public interest is involved. Given the restrictions on cost, the time devoted to peer review is not adequate and, hence, an alternative method that does not compromise the adequacy of the review needs to be found.

The Panel noted that a Quality Review Board (QRB) has been set up by ICAI with the intention of making recommendations to the Council regarding the quality of services provided by members of the Institute, to review the quality of services provided by them, including audit services, and to guide them to improve quality of service. However, it needs to start functioning in real terms at the earliest. Further, it added that for QRB to be really effective, it would be essential for it to play a more proactive role as an independent oversight body for the auditing profession in India, as has become the norm in most developed countries in the world; this would add credibility to the work done by Indian audit firms. The peer reviewer, Shri Sarda, felt that determining the role of QRB is of utmost importance for the functioning of the independent oversight mechanism. A decision has to be taken on whether or not the role of QRB would be along the same lines as the role of the Public Company Accounting Oversight Board (PCAOB) in the US or the equivalent quality oversight boards in Europe or Japan[121].

*Enforcing Discipline*

The Advisory Panel noted that the ICAI has a two-layer disciplinary process, *viz.,* Board of Discipline and Disciplinary Committee[122] in place. It also noted that with the Disciplinary Committee being bestowed more powers than the Board of Discipline, the process of reining in errant members would be more rigorous and strict and would also cut down on time. However, it felt that there is a need to accelerate the process of making the Board and the Committee really functional. Until the current backlog of disciplinary cases is eliminated, complaints received from regulatory authorities and government entities like banks, where greater public interest is involved, should be dealt with on a fast-track basis.

Complaints received from regulatory authorities and government entities like banks, where greater public interest is involved, should be dealt with on a fast-track basis.

The Listing Agreement of the SEBI has been instrumental in improving and strengthening the reporting and disclosure practices among the listed entities. Further, as per the recommendations of the SEBI Committee on Disclosures and Accounting Standards (SCODA) in August 2002, the stock

[121] The recent disclosure of massive falsification of annual financial statements and quarterly financial results submitted to the stock exchanges by a large publicly-listed company audited by a 'Big-4' auditing firm, reinforces the need for a much greater strengthening of the peer review process. It also highlights the need for the Quality Review Board to immediately start functioning and for it to play a pro-active role as an independent oversight body for the auditing profession in India.

[122] The Board of Discipline looks into complaints which fall under the First Schedule to the Chartered Accountants Act, 1949. The Disciplinary Committee looks into complaints against members falling under both the First Schedule as well as the Second Schedule to the Act.

exchanges are required to inform SEBI in cases where companies fail to remove audit qualifications and, in this endeavour, it was required to constitute an Advisory Committee to examine these cases and refer the matter to the Government to initiate necessary action under the Companies Act, 1956 and also to ICAI in cases where actions are required against the auditors of the company. SCODA, at its December 2006 meeting, had recommended that the auditors of the listed companies may be required to submit to SEBI financial statements containing audit qualifications and that SEBI may write to ICAI requesting them to advise its members suitably. The Panel, while recommending that this needs to be implemented in earnest, also recommended that guidelines may be prepared for determination of materiality of audit qualifications. The peer reviewer, Mr. Mackintosh, agreed with the approach of the Panel.

*Access to Working Papers and Issues Relating to Independence of Auditor and AASB*

ROSC-2004 had pointed out that the incoming auditor is not able to access the working papers of the outgoing auditor. The Panel reiterated the recommendation of ROSC-2004 and recommended that given the emergence of large corporate entities in India, where a company has a material subsidiary whose audit has not been done by the principal auditor, the principal auditor should have the obligation to review the working papers of the other auditors who have audited the financial statements of such subsidiaries.

The Panel noted that standards, though drafted by the AASB, are finally subject to approval by the Council which is the supreme body in the Institute and comprised practicing Chartered Accountants. However, given international practice, it recommended that there is a need to give functional independence to the AASB *vis-à-vis* the Council of the Institute by making it the final authority for drafting and issuance of the standards, with the Council confining itself to administrative, but not functional, control of AASB. The peer reviewer, Mr. Mackintosh, also felt that it was very important to give functional independence to AASB.

The Panel noted that the Companies Act, 1956 contains stringent provisions to protect the independence of the auditors. One such measure is restricting the fees from one client to 40 per cent of the total revenues of the firm. Having regard to the growth of the auditing profession and changes in the economics of audit firms and operating environment of the clients, the Panel felt that the limit of 40 per cent is too large. As the independence of the

auditor may actually or apparently be jeopardised by the time the limit of 40 per cent is reached, the Panel recommended that the limit be reduced to 25 per cent.

*Free Flow of Information Among Different Players in the Regulatory Framework*

The Panel noted that there are regulatory requirements of filing or submission of financial statements to various authorities like the Registrar of Companies, the Reserve Bank, SEBI and IRDA. In addition to the above, certain regulators, for example, the Reserve Bank undertake inspections of banks. It recommended that it would be most beneficial if there is a free exchange of information between the different players in the legal and regulatory framework, especially in relation to financial irregularities found by them.

### 5.5.4 Other Issues

*Responsibility of Auditors*

The Advisory Panel on Financial Regulation and Supervision observed that most market participants, especially those operating in the wholesale markets, are subject to audit/certification by external auditors/functionaries. Unlike bank auditors who are responsible to the Reserve Bank in the sense that appointment and removal of auditors by a banking company requires Reserve Bank approval, auditors of mutual funds, broking houses, and primary dealers are not accountable to the Reserve Bank/SEBI in any manner. To enhance the efficacy of regulation and augment accountability, the Panel recommended that the certification authorities/auditors should be made responsible to the respective regulatory authorities, to the extent that they are involved in certifying/auditing these entities that fall within the regulatory domain of the Reserve Bank/SEBI or any other regulator, as applicable. The Panel suggested that the matter should be discussed with ICAI/ICWAI/ICSI or any other similar body for the issuance of appropriate directions in this regard.

The CFSA feels that the recommendations given by this Panel should be considered.

### 5.5.5 Summary

The IAPC was constituted in October 1977 with the prime objective of enhancing the quality of and uniformity in auditing practices throughout the world and strengthening public confidence in the global auditing and assurance profession. It was renamed the International Auditing and Assurance Standards Board (IAASB) in 2002. The ISAs are widely accepted in India following efforts of the AASB in India.

ICAI was represented in the IAPC during its early years spanning 1980-86 and has, thus, played a role in drafting international standards. Though ICAI has taken steps to align Indian auditing standards with ISAs, there are still some gaps which need to be addressed in areas relating to convergence

As the independence of the auditor may be jeopardised by the time the limit of 40 per cent is reached, there is need to reduce the limit to 25 per cent.

with ISAs, implementation of auditing standards, strengthening the peer review, access to working papers and independence of auditors.

AASB should strive for convergence with ISAs and efforts also need to be made at the Institute-level in this regard. Efforts should be made to issue exposure drafts by the AASB when they are issued by IAASB. ICAI needs to take pro-active steps by bringing out more technical guidance and other literature to help SMEs understand new standards and aspects relating to their practical implementation. A strong message needs to be sent to practitioners that there is no option but to comply with the new requirements, by having a suitable deterrence mechanism in place. The Quality Review Board set up by ICAI needs to start functioning in real terms at the earliest. It should play a more pro-active role as an independent oversight body for the auditing profession in India. There is a need to accelerate the process of making the Board of Discipline and the Disciplinary Committee genuinely functional. The decision of SCODA regarding the auditors of the listed companies being required to submit to SEBI financial statements containing audit qualifications needs to be implemented in earnest. Where a company has a material subsidiary whose audit has not been done by the principal auditor, he should have the obligation to review the working papers of other auditors who have audited the financial statements of such subsidiaries.

There is a need to give functional independence to the AASB *vis-à-vis* the Council of the Institute by making AASB the final authority for drafting and issuance of the standards, with the Council confining itself to administrative, but not functional, control of AASB. The certification authorities/auditors should be made responsible to the respective regulatory authorities, to the extent that they are involved in certifying/auditing entities that fall within the regulatory domain of the Reserve Bank/SEBI or any other regulator, as applicable.

There is a need to accelerate the process of making the Board of Discipline and the Disciplinary Committee genuinely functional.

## 5.6 Business Continuity Management

While information technology has revolutionised the way financial institutions and markets conduct their business, it has also significantly increased their vulnerability to unexpected interruptions. Catastrophic events such as physical damage, loss or restricted access to facilities or resources and the failure of external services, such as power, could occur, which have the potential to interrupt essential business functions for an

unacceptable period. Hence, material adverse consequences for a financial system could occur, preventing market participants from completing transactions and meeting their obligations. Also repeated or prolonged interruptions of the operation of a financial system undermine confidence and could result in the withdrawal of capital from that system by domestic and global participants.

Managing business continuity is a crucial component of overall financial stability, especially in the context of large-scale dependence of the financial sector on IT-related systems (Box 5.6).

**Box 5.6 : Major BCM Initiatives by Regulators**

Financial authorities and financial industry participants have a shared interest in promoting the resilience of the financial system to unexpected disruptions and have been working closely to establish a consensus as to what constitutes acceptable standards for business continuity.

- At the international level, there have been several regulatory and private sector initiatives on the business continuity front. Legislation and regulations like Basel II, GLBA and Sarbanes-Oxley have been focusing on protection of the entire financial market, escalating BCM as a key regulatory requirement.
- In response to a request from the Financial Stability Forum in September, 2004, the Joint Forum determined that high-level principles on business continuity would make a beneficial contribution to the resilience of the global financial system.
- Events (including terrorism, computer crime and natural disasters) form a core component of 'operational risk"; all form a diverse range of risks that the Bank for International Settlements has defined as 'the risk of loss resulting from inadequate or failed internal processes, people and systems from external events'.
- In April, 2003, the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC) published an Inter-agency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.
- The Commodity Futures Trading Commission (CFTC) approved a National Futures Association (NFA) rule that became effective on July 1, 2003. Compliance Rule 2-38 (the Rule) requires all NFA members to establish and maintain a written business continuity and disaster recovery plan that outlines procedures to be followed during an emergency or a significant business disruption.
- The U.S. SEC released a Policy Statement on Business Continuity Planning for Trading Markets. The Commission believes self-regulatory organisations operating trading markets (SRO Markets) and electronic communications networks (ECNs) should implement business continuity plans reflecting a set of principles no later than the end of 2004.
- In June 2003, the Monetary Authority of Singapore (MAS) issued Consultation Paper 142: 'Guidelines on Business Continuity Planning'.
- In July 2002, the Financial Services Authority (FSA) issued Consultation Paper 142: 'Operational risk systems and controls' that outlined several regulatory expectations.

**Source :** Bank for International Settlements, official website of CFTC, SEC, MAS, FSA, Federal Reserve.

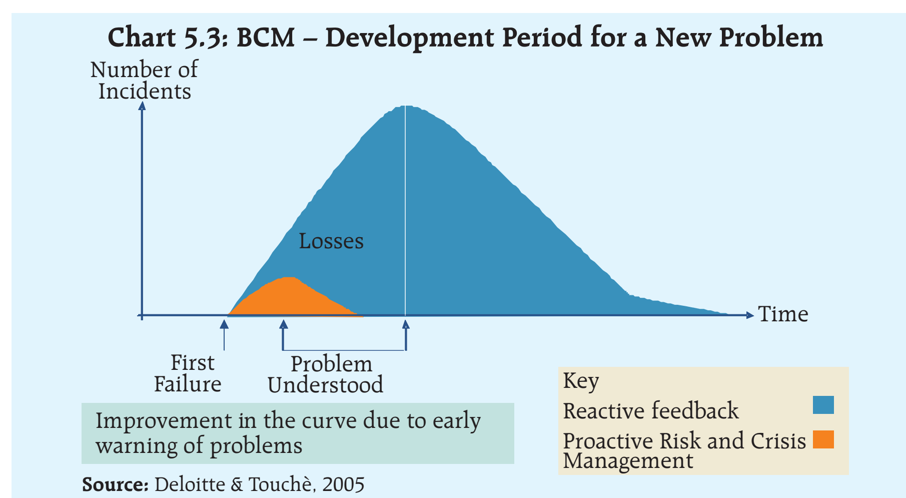
Managing business continuity is a crucial component of overall financial stability.

Business Continuity Management (BCM) involves arranging for emergency operations of these critical business functions and for their resource recovery planning after natural or man-made disasters. The earlier the problem is taken care of, the less the impact of loss is likely to be. As may be observed from Chart 5.3, in the case of reactive feedback, action can be initiated only after a problem is reported. On the other hand, with a proactive risk and crisis management, like BCM, the organisation actively seeks feedback on potential or actual problems and then undertakes remedial measures as soon as practicable. The difference between the two curves represents the magnitude of potentially preventable losses.

Looking to the importance of business continuity, the Advisory Panel on Financial Stability Assessment and Stress Testing undertook an exercise for select commercial banks to ascertain their level of preparedness with regard to business continuity by formulating a questionnaire based on the *High Level Principles of the BIS Joint Forum.* Summarising the responses, the Panel observed that the majority of the respondents had taken action on several facets of BCM. However, areas of concern remained, particularly in aspects related to human resource management and assessment of the business continuity processes of vendors. The Panel said that banks must continuously test and upgrade their BCM plans incorporating new or change features in their business, developments and technology improvements.

The Panel also made an assessment of the BCM policy of CCIL, which provides clearing and settlement functions for trades in government securities, CBLO and foreign exchange and is under the regulatory and

**Chart 5.3: BCM – Development Period for a New Problem**




**Source:** Deloitte & Touchè, 2005

supervisory oversight of the Reserve Bank. Despite its resilience, the BCM policy of CCIL exhibited certain shortcomings in communication procedures, management succession and training of alternate staff in case of an emergency.

Keeping in mind the critical nature of the operations performed by the Reserve Bank, the Panel made an assessment of whether its main areas of activity were being performed in a continuous manner. In order to ensure that the BCM is in a readily executable form, the Reserve Bank itself conducts regular BCM exercises, where all banks, other related entities, and CCIL also participate. One such drill conducted in February 2008 indicated that although the exercise was conducted in a satisfactory manner and live operations were completed from the Reserve Bank's DR-site, some participants, in spite of having adequate systems to take care of Business Continuity, needed to ensure that these systems operated with ease in case of a contingency

The Panel, therefore, noted that overall, though the Reserve Bank, CCIL and the banks assessed, were well aware of the need for an effective BCM policy and were moving towards the same, certain issues continued to pose a hindrance:

- Outsourcing as a means of both reducing cost and accessing specialist expertise has gained credence. However, it could lead to certain risks, which could in turn lead to financial losses/reputational risk for the bank and could also lead to systemic risks within the entire banking system.
- Third-party service providers having access to bank's data, systems and network could misuse the same.
- Threats from unresolved computer malware and unauthorised access to secure websites.

The recommendations were broadly in the areas of risk assessment, outsourcing issues, challenges in technology upgradation, impact of computer malware, cross-border cyber laws and HR issues. The Panel gave a detailed list of recommendations[123]. These include:

- Risk Assessment and scenario planning: While the focus of business continuity measures is to enhance availability of systems and services, the BCM programme should embed a comprehensive risk assessment process.
- Market-wide simulation with all participants: A co-ordinated response to any eventuality is important and that is why exercises need to be conducted 'market or industry-wide' within major financial centres to test collective responses, decision making and the inter-connectivity of business continuity arrangements.

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[123] For a detailed assessment and recommendations refer Volume III - Advisory Panel Report on Financial Stability Assessment and Stress Testing.

It is the responsibility of both the regulator and the regulated to continuously upgrade and monitor the BCM process

- Incident response capability: It is important for organisations to develop incident response capability to assess the impact of insignificant incidents that merely impact operational efficiency as an indicator of possible bigger disasters, and update the business continuity plan and recovery measures accordingly.
- Training: In order to keep the business continuity plans current in a technology-enabled area, there is a need to make employees aware of their responsibilities and recovery planning.
- Guidelines for BCM of third parties: Service providers form an essential component of organisation's business continuity preparedness. Hence, there is a need for greater participation and integrated response capability for service providers who provide services from remote sites.
- System maintenance and change control: These are processes designed to measure and evolve the systems in accordance with the changing business requirements, in such a manner that the system continues to deliver its stated objectives.
- Fraud monitoring systems: Banks should closely monitor the main areas, broadly classified under identity-related and transaction-related opportunities, where tighter controls can facilitate in combating fraud. Internally, the best way to fight fraud is to have a strong corporate compliance mechanism with anti-fraud professionals monitoring the process.

The CFSA concurs with the view of the Panel and feels that it is the responsibility of both the regulator and the regulated to continuously upgrade and monitor the BCM process in banks and other financial institutions. The CFSA feels that in addition to mitigating risks emanating from IT-related issues, issues relating to appropriate succession planning and proper delineation of duty in the event of a major operational disruption and continuous upgrading of training, particularly for personnel operating in the alternate sites, could be considered imperative for an appropriate BCM. Of equal importance are issues relating to proper MIS and factoring in BCM as an integral part of operational risk management for institutions. While the Reserve Bank has issued guidelines to banks sensitising them to the importance of BCM in the area of operational risk, capacity building on the part of the regulators to assess the state of BCM in the regulated entities could also be a major area of focus.

In addition to IT related issues, proper succession planning, MIS and capacity building are some areas which need to be focused on.

### 5.6.1 Summary

While information technology has revolutionised the way financial institutions and markets conduct their business, it has also significantly increased their vulnerability to unexpected interruptions. Managing business continuity has been perceived as a crucial component of overall financial stability, particularly in the context of the large-scale dependence of the financial sector on IT-related systems.

In India, it is observed that financial market participants had taken action on several facets of BCM. However, areas of concern, particularly in aspects related to human resource management and assessment of the business continuity processes of vendors, remained.

Certain features which should be kept in mind for framing a BCM programme are:

- Risk assessment and scenario planning
- Market-wide simulation with all participants
- Incident response capability
- Training
- Guidelines for BCM of third parties
- System maintenance and change control
- Fraud monitoring systems

It is the responsibility of both the regulator and the regulated to continuously upgrade and monitor the BCM process in banks and other financial institutions. In addition to mitigating risks emanating from IT-related issues, issues relating to appropriate succession planning and proper delineation of duty in the event of a major operational disruption and continuous upgrading of training, particularly for personnel operating in alternate sites, should be considered imperative for an appropriate BCM.

## 5.7 Payment and Settlement Infrastructure

The smooth functioning of the payment and settlement systems is a pre-requisite for stability of the financial system. Central banks all over the world have assumed the responsibility of putting in place sound and efficient payment and settlement systems. In India, a number of measures have been initiated to improve the efficiency of both large-value and retail payment systems. The launching of Real Time Gross Settlement System (RTGS) has led to a reduction of settlement risk in large-value payments in the country. The setting up of National Securities Depository Ltd. and Central Depository Services (India) Ltd. for capital market settlements and Clearing Corporation of India Ltd. for government securities, foreign exchange and money market settlements has improved efficiency in market transactions and settlement processes.

In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment and Settlement Systems

(BPSS) was set up in March, 2005 as a Committee of the Reserve Bank's Central Board. The Board is entrusted with the role of prescribing policies relating to the regulation and supervision of all kinds of payment and settlement systems, setting standards for existing and future systems, authorising the payment and settlement systems and determining the criteria for membership to these systems, including the continuation, termination and rejection of membership.

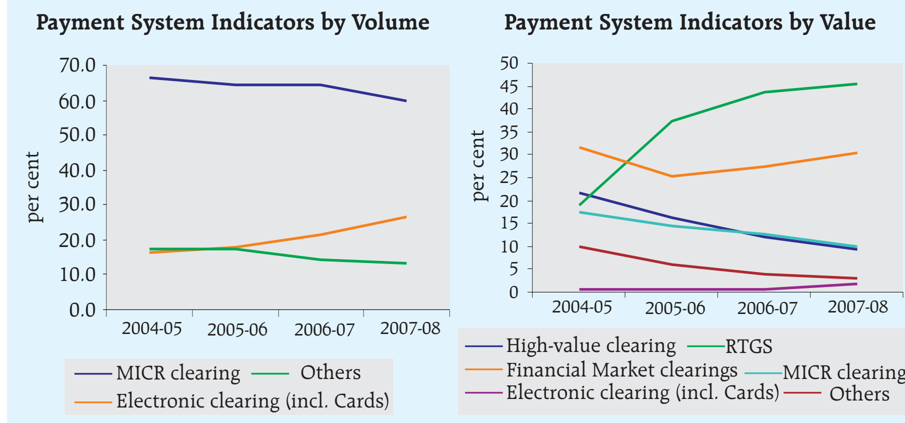
A series of legal reforms to enhance the stability of the payment systems, like the introduction of the Information Technology (IT) Act, 2000 that recognises electronic payments, an amendment to the Negotiable Instruments Act, 1881 to enable cheque truncation and to define e-cheques, have been carried out. While these amendments helped promote electronic payment, they could not provide an all-encompassing solution to the requirements of providing a legal basis for payment and settlement systems. Illustratively, the statutes did not provide for legal backing for multilateral netting. There was no legal basis for settlement finality. Also, the system did not provide for any law for regulation and supervision of payment systems. In order to address these issues, the Payment and Settlement Systems Bill was passed in 2007. This Act has recently come into effect, with the regulations under it having been notified.

The efficient management of liquidity is of prime importance to banks in the RTGS system. In the Indian context, to address intra-day liquidity requirements, the Reserve Bank has been providing collateralised intra-day liquidity, free of cost, to participant banks. Multilateral netting arrangements using Central counterparties (CCPs) have also gained prominence in settlement of trades in securities, foreign exchange and derivative instruments. Liquidity requirements of CCIL though remain a cause for concern.

Concomitant with the growth of the economy, there has been a significant increase in both the volume and value of transactions through the Systemically Important Payment Systems (SIPS). RTGS constitutes the largest segment in terms of value (Chart 5.4).

The Advisory Panel on Financial Stability Assessment and Stress Testing has made certain recommendations to strengthen the efficiency of payment and settlement systems in the following areas:

i. High Value Clearing System, which is a non-guaranteed settlement system, constitutes a significant 10 per cent of the total payment




system in terms of value. Shifting high value transactions to a more secure electronic payment system, like RTGS, would be a useful step in mitigating the risks emanating from dependence on paper-based High Value Clearing System.

ii. The total value of credit card transactions has more than trebled between 2003-04 and 2007-08. This trend is likely to continue. Since credit card transactions are increasingly prone to fraud, it is critical to stay abreast of the latest developments in this area to combat fraud effectively. Some solutions to mitigating the problem with credit card fraud suggested by the Panel are:

a) Authentication for controlling access to critical systems.

b) Use of Personal Identification Number (PIN) for authenticating debit card transactions at merchant sites.

c) End-to-end encryption of credit and debit card transactions, including that between point-of-sale terminals and the acquiring bank server.

d) Establishing Information Security by banks and institutions.

e) Adoption of Fraud Prevention Technology as per 'Need for High Level of Encryption Standard for E-commerce Security'.

iii. Given the rapid growth of mobile telephony, it is felt that in the medium-term, telecom system providers would play a growing role as payment system facilitators particularly through mobile phones. However, several impediments need to be ironed out in the interim, including the development of appropriate risk management skills. There should be regulatory guidelines focusing on security of the transaction, fraud prevention and the relationship between the telephone service provider and the banking system. The Reserve Bank had placed a paper on mobile banking in the public domain and the guidelines are now being finalised. The Reserve Bank had issued a draft

High value transactions could be shifted to RTGS.

'Financial Sector Technology Vision 2008-10' document, wherein it has been mentioned that efforts would be channelised to provide standards for such systems and a suitable regulatory/oversight framework. The draft document mentions that the large-scale spread of mobile telephony has opened up new vistas for banking in the form of mobile banking and the potential in this new sphere is enormous. However, adequate steps to ensure safety and security in a mobile-based computing/communicating environment need to be taken.

Now that the notification of regulations under the Payment and Settlement Systems Act has been issued, the above recommendations of the Panel should be considered by the Reserve Bank for implementation.

**5.7.1 Assessment of Payment and Settlement Systems Standards**

*Benchmarks*

This decade has seen significant progress in the development of payment and settlement systems standards. In addition to the *'Core Principles for Systemically Important Payment Systems*' (SIPS) issued in January 2001, the CPSS-IOSCO Task Force on Securities Settlement Systems (SSS), building on earlier work, made *Recommendations on the Securities Settlement Systems* in November 2002. Taking into account the systemic importance of the Central Counter-party (CCP) and its role in the SSS, the CPSS-IOSCO brought out in November 2004, *Recommendations for CCPs* which set out comprehensive standards for risk management of CCPs. Based on these developments, the Advisory Panel widened the scope of the current assessment as compared to the earlier assessments. The assessment covers the extant standards and codes in payment and settlement systems prescribed by the CPSS for SIPS, and CPSS-IOSCO Recommendations for the SSS and CCPs (Box 5.7).

Although no specific standards have evolved for retail payment systems, taking into account the wide use of these systems by the public at large in India, including pensioners, the Panel has also attempted a review of the status of India's retail payment systems, and assessed the systems, to the extent feasible, against the guidelines issued for Magnetic Ink Character Recognition (MICR) cheque-processing centres and the standards for computerised clearing-houses.

Adequate steps to ensure safety and security in a mobile-based computing/ communicating environment need to be taken.

*Earlier Assessments*

The payment and settlement systems were assessed earlier as part of the FSAP of the IMF and the World Bank in 2001 and by an Advisory Group

**Box 5.7: Standards in Payment and Settlement Systems**

The international standards in payment and settlement systems are:

The *Core Principles for Systemically Important Payment Systems* (CPSIPS) developed by the Committee on Payment and Settlement Systems (CPSS) in 2001; the CPSS-IOSCO *Recommendations for Securities Settlement Systems* - 2001; and the CPPSS-IOSCO *Recommendations for Central Counterparties* - 2004.

***Core Principles for SIPS***

The Principles encourage the design and operation of a safe and efficient payment infrastructure. The principles cover:

i) Legal Foundation: The systems should have well-founded legal foundation.

ii) Effective Risk Management: Envisages clearly-defined procedures for management of credit and liquidity risks, ensures prompt final settlement on the day of value, and also ensures that assets used for settlement should carry little or no credit and liquidity risks.

iii) Security and Operational Reliability: Envisages security, operational reliability and contingency arrangements for payment systems.

iv) Efficiency and Level Playing-field: The systems should be efficient, cost-effective and publicly disclose criteria for participation.

v) Governance: Should be efficient, accountable and transparent.

*Responsibilities of Central Banks in Applying the Core Principles*:

The four responsibilities of central banks envisage disclosure of the role of the central banks in payment systems, the central banks should ensure compliance with the core principles, and promote the efficiency and safety of the payment systems.

***Recommendations for Securities Settlement Systems***

The 19 recommendations are considered to be minimum standards intended to reduce risks, increase efficiency, provide adequate safeguards for investors, and enhance international financial stability in securities settlement systems. Those recommendations recognise the importance of securities settlement systems for the infrastructure of global financial markets and they note that weaknesses in securities settlement systems can be a source of systemic risks to securities markets and to other payment and settlement systems. The recommendations are designed to cover securities settlement systems for all securities, including equities, corporate and government bonds, and money market instruments.

They provide detailed descriptions of the institutional arrangements for confirmation, clearance, settlement, and safekeeping of securities. They also address specific issues, including the legal framework for securities settlements, risk management, access, governance, efficiency, transparency, and regulation and oversight.

The recommendations describe the risks in settlement systems, *viz.*, credit risk, liquidity risk and counter-party risk and provide a wide range of measures to address them. Other risks involved in settlement activities are legal risk, custody risk, operational risk, and the risk of a settlement bank's failure. The recommendations define some rules for trade confirmation, settlement cycles, central counterparties, and securities lending. In particular, the recommendations require that trade confirmation take place on the same trade date and that rolling settlement should be adopted in all securities markets. The recommendations discuss the sources of settlement risks and provide several measures to address them. To reduce

operational risk, the recommendations require CSDs to identify and minimise the source of operational risk through the development of appropriate systems, controls, and procedures. The recommendation on assets protection requires the custodians to put in place measures that fully protect customers' securities. The recommendations identify the key mechanisms to promote market efficiency. A specific recommendation addresses the regulation and oversight of securities settlement systems. It calls for transparent and effective regulation and oversight to ensure the safety and efficiency of such systems, and for co-operation between central banks and securities regulators to avoid unnecessary cost and to promote adequate information sharing.

***Recommendation for Central Counterparties***

The CPSS-IOSCO Recommendation for central counterparties covers the following:

*Legal Risk:* A CCP should have a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

*Participation Requirements:* A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.

*Measurement and Management of Credit Exposures:* A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

*Margin Requirements:* If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

*Financial Resources:* A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme, but plausible, market conditions.

*Default Procedures:* A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.

*Custody and Investment Risks:* A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

*Operational Risk:* A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.

*Money Settlements:* A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.

*Physical Deliveries:* A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

*Risks in Links Between CCPs*: CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.

*Efficiency:* While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

*Governance:* Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and, to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

*Transparency:* A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

*Regulation and Oversight:* A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should co-operate with each other and with other relevant authorities.

constituted by the Standing Committee on International Financial Standards and Codes around the same period.

The FSAP Report observed that though the Reserve Bank played a pivotal role in the payment system, both as a participant and as a regulator, India's compliance with the core principles was only partial, particularly with regard to the lack of legal and contractual framework relevant to the payment and settlement systems, multilateral netting arrangements used in clearing were not backed by legislation and real-time finality was not assisted by bankruptcy legislation. The FSAP Report highlighted the fact that procedures in the event of a default – 'partial unwind' of transactions of defaulting institutions – could have serious systemic implications. Though the limits on the maximum amount of risk that could be taken by participants in the payment system were clearly defined, they did not meet the required standards. The Report also stated that the security of SIPS in India was low. The Report concluded that the introduction of RTGS, which would handle all large-value payments, would greatly enhance compliance, boost efficiency and lower the risks in the payment system.

The Advisory Group to assess the observance of standards and codes relevant to the payment and settlement systems submitted its Report in three parts in 2000-01, covering clearing house operations, settlement in equity and debt markets and foreign exchange transactions. In respect of SIPS, the focus of the Group was on the introduction of Lamfalussy standards as a minimum benchmark and to develop appropriate mechanisms for an RTGS system. Compliance with G-30 recommendations on SSS was the focus for equity and debt segments, while for the foreign exchange segment, the Group made recommendations entailing actions that CCIL could use, in conforming to international practices and principles. Based on the assessment, the Group recommended a set of actions which could be initiated by CCIL. Some of the important measures included establishment of a Clearing Agent abroad by the CCIL, institution of a separate guarantee fund for foreign exchange clearing and appropriate integration between the participating banks and CCIL and their interface with the RTGS system.

A Review Report published in December 2004 noted that significant progress has been made in implementing the recommendations of the Advisory Group Report. The Review noted that the operationalisation of RTGS marked a significant progress in respect of some important recommendations made by the Advisory Group on Payment and Settlement Systems. The introduction of same-day and intra-day settlement helped in significantly complying with international standards. Enactment of the legislation covering payment and settlement systems could help strengthen the legal framework covering the payment and settlement systems and help make further advances towards meeting the best practices advocated as part of the international financial standards and codes.

### 5.7.2 Assessment by the Advisory Panel on Institutions and Market Structure

The findings of the Advisory Panel regarding adherence of participants in India to most of the standards prescribed for the payment and settlement systems were quite favourable. The assessment shows that the standards are observed by the participants with some departures. No significant weaknesses were identified with respect to either high value payment systems or securities settlement systems, while the shortcomings in the functioning of the CCPs were relatively minor.

Mr. Greg Johnston, Head of Banking, Reserve Bank of Australia, peer reviewed the Panel's Report on Payment and Settlement Systems. He agreed

that significant progress has been made in the development of India's financial markets in general and payment and settlement infrastructure in particular. As suggested by him, the Panel has treated the RTGS and High Value Clearing Systems as SIPS. The suggestions made by Mr. Johnston on the various assessments were accepted by the Panel and the Report was suitably amended. He stated that the legislation supporting the legal certainty of settlement finality in SIPS, and netting in financial markets is a very important step and critical to being able to make a strong and unqualified case that the RTGS System, CCPs and net securities settlements comply with key international standards. With the notification of the Payment and Settlement Systems Act, this has been achieved.

### 5.7.21 Assessment of Adherence to Core Principles for Systemically Important Payment Systems

The CPSS Core Principles for SIPS encourage the design and operation of safer and more efficient SIPS. The 10 Core Principles cover the legal basis, settlement of trades, risk control and management, governance, efficiency and transparency of the SIPS. The 'Responsibilities of Central Banks' in applying SIPS define the roles and responsibilities of central banks in oversight and regulation of the systems and ensuring compliance with the Core Principles. Based on the criteria outlined by CPSS, the RTGS system and the High Value Clearing system in the country have been identified as SIPS.

The Advisory Panel noted that the RTGS system is owned and operated by the Reserve Bank and currently operates the settlement of inter-bank and customer transactions with 107 members. The membership of RTGS is open to all Scheduled Commercial Banks, Primary Dealers and as may be decided by the Reserve Bank. Other banks and financial institutions can participate as customers of the direct members. The settlement of RTGS transactions takes place in the books of the Reserve Bank. Members are provided with a collateralised Intra-day Liquidity (IDL) facility to tide over their intra-day liquidity mis-matches.

High Value Clearing is a paper-based clearing system for large value payments held at 27 major cities in the country for cheques of Rs.1 lakh and above and payable locally, which are cleared the same day. The clearing and settlement infrastructure provided by CCIL constitutes a major portion of the settlements that happen in the country. The final settlement of funds position in these clearing and settlements is effected in the RTGS system.

The Panel has treated the RTGS and High Value Clearing Systems as Systemically Important Payment Systems

The Advisory Panel observed that the Reserve Bank has been provided a sound and well-founded legal basis for regulation and oversight of payment and settlement systems in the country following the enactment and notification of the Payment and Settlement Systems Act in 2007 and 2008, respectively. The Act clearly defines settlement finality and provides an explicit legal basis for multilateral netting. RTGS (Membership) Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004 which have been notified under the Payment and Settlement Systems Act, 2007

The existing payment system operates cheaply and efficiently, with minimal systemic risk.

provide for the responsibilities of the operator and participants in RTGS. High Value clearing is guided by the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH), which defines the rights and obligations of participating banks. The Reserve Bank aims to ensure that the SIPS in the country fully observe the core principles prescribed by CPSS. Subsequent to the formation of the BPSS, a number of steps have been taken under the guidance of the Board to make the SIPS in India fully compliant with the core principles.

The findings of the CPSS Core Principles assessment are that the existing payment system operates cheaply and efficiently, with minimal systemic risk. The assessment of the Indian RTGS system against the 10 core principles for SIPS showed that of the 10 Core Principles, the system 'Observed' six Principles broadly covering legal basis, settlement of trades, governance, efficiency and transparency; three were 'Broadly Observed' covering risk management and control; and one Principle was 'Not Applicable'. Of the four Responsibilities for central banks as applicable to SIPS covering transparency, safety and efficiency, three have been assessed as 'Observed' and one as 'Broadly Observed'. It is observed from the assessment of the High Value Clearing System that the system 'Observed' eight of the Core Principles, one was 'Broadly Observed' and one 'Partly Observed' (Table 5.3).

The issues highlighted by the Advisory Panel and the corresponding recommendations are summarised below. The CFSA concurs with the recommendations of the Panel.

*Settlement in Commercial Bank Money*

The settlement in High Value clearing happens at the locations where the clearing facility is provided. At 17 centers where the Reserve Bank manages the clearing, the settlement takes place in the current accounts maintained by the participating banks at the Reserve Bank; at the other centres, the settlement banks are commercial banks. The settlement banks in these cases are major public sector banks in the country. To a great extent, the system operators take the responsibility to ensure that the settlements go through smoothly. However, in respect of the settlement which takes place in commercial bank money, the risk management measures need further review.

In respect of the settlement which takes place in commercial bank money, the risk management measures need further review.

*Settlement Risk*

The High Value Clearing System settles on multilateral netting basis. This settlement does not have any arrangement to ensure completion in the event of an inability to settle by the participants with the largest single

**Table 5.3: Summary Assessment – Systemically Important Payment Systems**

| | Principle | RTGS | High Value Clearing System |
|---|---|---|---|
| | | Assessment | |
| CP I. | Legal Basis | O | O |
| CP II. | Clarity of rules and procedures | O | O |
| CP III. | Risk Management | BO | BO |
| CP IV. | Finality of settlement | O | O |
| CP V. | Timely completion of multilateral net settlement | NA | PO |
| CP VI. | Settlement in central bank money | O | O |
| CP VII. | Security and operational reliability | BO | O |
| CP VIII. | Efficiency | BO | O |
| CP IX. | Public disclosure of participation criteria | O | O |
| CP X. | Transparency in governance arrangements | O | O |
| **Responsibilities of Central Banks** | | | |
| A | Transparency of roles and major policies | O | O |
| B | Compliance with Core principles | BO | BO |
| C | Oversight of Payment Systems | O | O |
| D | Co-operation with other central banks | O | O |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

settlement obligation. Settlement risk in this system is addressed through a mechanism of partial unwinding of the transactions related to the defaulter. The Advisory Panel recommended that the Reserve Bank should consider migrating all high value transactions to secure electronic channels like RTGS and NEFT.

*Security and Operational Reliability of SIPS*

A high degree of security and reliability is achieved in the High Value Clearing System. In the RTGS system, the on-site hot back-up is in place while a dedicated off-site DR site is in the final stages of implementation. Once implemented, the site would provide a high degree of security and operational reliability.

*Efficiency*

The Reserve Bank as the overseer of the payment and settlement systems has taken several initiatives to increase efficiency of the system by inducting technology and changes in procedures. The commercial banks as participants are effective partners in this process. All large value payments (HV clearing and RTGS) are settled on value date, leading to immediate turnover of funds. Though the Reserve Bank does not levy any processing charges, the RTGS system charges are still priced relatively higher by banks for customer transactions compared to charges for clearing paper-based instruments. The level of utilisation of the electronic payments infrastructure has been sub-optimal. The Panel recommended that steps may be taken to optimise the utilisation of the electronic payments infrastructure and reduce the charges for such transactions.

The level of utilisation of the electronic payments infrastructure has been sub-optimal.

*Transparency*

The access criteria laid down for becoming members of the clearing house are explicit and publicly disclosed. The criteria for participation in RTGS are also available in the public domain. The clearing houses have various standing committees where all major decisions are discussed and approved by the members. The Panel suggested that the decisions taken at the Standing Committees of various SIPS should be communicated to the members more promptly.

*Central Bank Responsibilities*

The Reserve Bank has formal powers to perform oversight of the payment systems it does not operate after the notification of the Payment and Settlement Systems Act, 2007. The Reserve Bank has now started publishing its oversight documents highlighting its vision of the payment and settlement system, but has yet to disclose publicly its role with respect to SIPS. The Panel recommended that a document on this may be published by the Reserve Bank.

*Retail Payment Systems*

The retail payment systems in the country consist of paper-based instruments such as cheques (MICR/non-MICR clearing), and drafts, electronic modes such as Electronic Funds Transfer system (EFT) and National Electronic Funds Transfer (NEFT), Electronic Clearing Systems (ECS) and payment channels, like card-based instruments (also known as plastic), the internet and mobile phone-based products.

*Position of India in Cheque Clearing vis-à-vis Other Countries*

No country provides a system which provides same day settlement of high value cheques, as India does.

In most countries, the general trend has been to reduce the use of cheques as a payment instrument and introduce cheque truncation systems to reduce the settlement cycle. The cheque clearing system in India ranks above all countries in terms of the settlement cycle. It takes only two days for the deposit of a cheque to realisation of the proceeds in local clearing systems, whereas in the UK, both cheque and credit clearings operate on a three-day payment and settlement cycle, and an additional day is sometimes necessary for items requiring cross-border clearing between England and Scotland. In the US, the finality of the settlement is not achieved on completion of the process as the banks can return the cheques within 30 days. Further, the High Value Cheque Clearing operated in India is unique. No country provides a

system which provides same day settlement of high value cheques, as India does.

*Deficiencies in Retail Payment Systems*

Deficiencies in retail payments mainly pertain to the inefficient outstation cheque collection process. In this regard, it is difficult to prescribe a standard timeframe for collection in view of large disparities at various centres, in terms of their location, availability of infrastructure and communication facilities. In metropolitan cities and other state capitals/A-class cities, most banks have a policy of collecting instruments within a period of 7 to 10 days. In other cities and States in the north-eastern region, most banks have declared in their policies that the instruments will be collected within a maximum period of 14 days. The CFSA notes that the Reserve Bank is co-ordinating with IBA for achieving inter-connectivity of branches through VSATs. The cheque truncation process may also be expanded once the system is successfully implemented in New Delhi in order to streamline the outstation cheque collection process. The Reserve Bank may strive for 100 per cent computerisation of clearing house operations.

Deficiencies in retail payments mainly pertain to the inefficient outstation cheque collection process.

The usage of ECS has seen a rapid increase during the period of assessment. The main deficiency in the ECS system has been the decentralised model of transaction processing in the system. While a centralised ECS has been provided, this is available only for Reserve Bank centres. To address this deficiency, a National Electronic Clearing Platform was implemented in September 2008.

The other deficiency that remains in the system is that the benefits of facilities like ECS and RTGS are not trickling down to the lower end of the customer segment. They still largely use services like money orders and informal channels which have a much higher cost and longer time lag for transferring money. There is a need to develop solutions using newer technologies that allow all segments of society to gain access to the benefits offered by these facilities. There are examples of such facilities being provided to the marginally banked and the unbanked segments in other developing geographies that can be studied for guidance. Given the high level of software capabilities available in India, it is of the utmost importance that this process be accelerated and that India leapfrog intermediate steps and move rapidly to IT-based systems.

The current low utilisation of the electronic payments infrastructure can be increased by using technology to make the facilities more accessible to customers. Currently, banks allow their customers to use the internet for money transfer facilities like EFT, but the limited reach offered by the internet is a barrier to expanding usage through this route. Enabling usage of these facilities on mobile devices, which have high penetration levels, could result in a large portion of the population gaining access to these facilities.

The benefits of facilities like ECS and RTGS are not trickling down to the lower end of the customer segment.

The development of funds transfer or payment systems through mobile phones would not only reduce transaction costs, but would potentially

also allow these facilities to be used by a large unbanked segment. Given that, in coming years, mobile phone penetration will be much larger than banking penetration, this would allow the benefits of technology to trickle down the pyramid and allow the banking community to develop products that are currently either unfeasible or unprofitable.

### 5.7.22 Assessment of Adherence to the CPSS-IOSCO Recommendations for Securities Settlement Systems

The CPSS-IOSCO *Recommendations for Securities Settlement Systems* (SSS) is intended to enhance the safety and efficiency of the SSS. These recommendations help in assessing the SSS for its legal basis, settlement practices, risk management, governance, efficiency and accessibility, transparency and regulation and oversight. There are two SSS in India, namely, the Government Securities Settlement System and the Equities Settlement System.

#### *Government Securities Settlement*

The Advisory Panel observed that the infrastructure for government securities settlement systems in India is provided by the Reserve Bank wherein the Public Debt Office (PDO) in the Reserve Bank functions as the depository. CCIL is the CCP for settling transactions in government securities. All government securities transactions are settled through CCIL on a net basis on DvP III. The funds and securities are cleared by CCIL and sent to SSS for settlement. The funds legs are settled by the SSS in RTGS. The final settlement for the securities transactions takes place in the books of the Reserve Bank at the end of the settlement day. Since all the transactions are settled through CCIL, the risk control measures are operated by CCIL. CCIL has established detailed mechanisms and procedures through prescriptions of counterparty credit exposures and margining system to control the risks it is exposed to as CCP. The CCIL's risk management practices are periodically evaluated against recommendations for CCP. The Reserve Bank does not impose any fee/service charges for using the trading and reporting system; however, the CCIL levies charges in consultation with market participants/ user groups. Secondary market transactions in government securities are settled in the books of the Reserve Bank for both the securities leg and funds leg on a DvP basis. All relevant information is made available to participants and is also available in the public domain.

The laws, rules and regulations governing the SSS are contained in the Securities Contracts (Regulation) Act (SCRA) and the Government Securities

(GS) Act. The GS Act, 2006 and the GS Regulations, 2007 have been brought into force from December 1, 2007 superseding the Public Debt (PD) Act, 1944 except in respect of Jammu and Kashmir. The secondary market transactions are on a contractual basis and are covered by the Contract Act and enforceability is under the Contract Act. The netting by novation performed by the CCP is covered by the Contract Act.

The GS Act supports dematerialisation of securities. Full dematerialisation of government securities (with the exception of a small quantum of stock certificates) has been achieved for wholesale transactions. Only securities which are in a dematerialised form, are held with custodians; the physical securities are held by the beneficial holders themselves. The Act confers ownership of the securities in custodian accounts with the beneficial owners in the case of insolvency of the custodian.

The settlement system is fully automated with regular BCP testing. All outright securities transactions are settled on T+1 rolling basis. All secondary market transactions are submitted to settlement systems electronically and confirmations are completed on the trade date itself on NDS. Repo transactions can have T+0 and T+1 settlement. There are internal guidelines and procedures including security measures designed to limit operational risk.

The settlement of government securities is an integral part of the Reserve Bank's operations and is subject to internal oversight. The Reserve Bank assesses the SSS through its regular inspection in a pre-determined schedule and also through concurrent audit appointed by it and the Control Self-Assessment Audit. The CCIL, as a CCP, is subjected to periodic oversight by the Reserve Bank based on CPSS-IOSCO standards. The responsibility of the Reserve Bank with regard to government securities settlement is defined in the GS Act, 2006. There is, at present, no other security settlement system for government securities outside the Reserve Bank.

Given the practices in the SSS, the government securities market is compliant with the CPSS-IOSCO Recommendations for Securities Settlement Systems. Of the 19 Recommendations, 17 have been assessed as 'Observed' while two are 'Not Applicable' (Table 5.4).

***Equity Market Settlement Systems***

In 1956, the Central Government notified the SCRA for trading and governance of exchanges. The setting up of SEBI in 1992 gave a major thrust to reforms in the securities market. Since then, the market has undergone a major transformation in terms of its structure, products, practices, spread, institutional framework and other important aspects like transparency, integrity and efficiency. The size of the market has also grown manifold.

*Assessment of Equity Market Settlement Systems*

The major stock exchanges – NSE and BSE – and their CCPs (National Securities Clearing Corporation and the Bank of India Shareholding Ltd.) have well-laid down rules, bye-laws and regulations regarding their operations. The

| Table 5.4: Summary Assessment – Recommendations for Securities Settlement Systems | | |
|---|---|---|
| Recommendation | Government Securities Settlement | Equities Settlement |
| | Assessment | |
| 1. Legal basis | O | O |
| 2. Confirmation of trades | O | O |
| 3. Rolling settlement | O | O |
| 4. Benefits and costs of central counterparties | O | O |
| 5. Securities lending and borrowing | O | BO |
| 6. Dematerialisation of securities | O | O |
| 7. Elimination of principal risk | O | O |
| 8. Final settlement | O | O |
| 9. Risk management in deferred net settlements | O | O |
| 10. Credit risk in the cash leg of securities transactions | O | O |
| 11. Operational risk | O | O |
| 12. Accounting practices | O | O |
| 13. Governance arrangements for CSDs and CCPs | O | O |
| 14. Participation criteria for CSDs and CCPs | O | O |
| 15. Safety, security and efficiency of systems | O | O |
| 16. Communication procedures | NA | O |
| 17. Information on risks and costs | O | O |
| 18. Disclosure of responsibilities and objectives of settlement systems | O | O |
| 19. Risks in cross-border settlement | NA | NA |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

ownership and financial information is available with the statutory and regulatory authorities and is also publicly available. Periodical reports containing operational and financial information and major decisions are periodically sent to members of the Board, shareholders and regulatory authorities. The exchange and the CCPs have well-laid down norms pertaining to admission and exit of the market participants, *viz.*, broker members, custodians and clearing members, which are publicly available.

The main laws, rules and regulations governing securities settlement arrangements are contained in SCRA, Securities Contracts (Regulation) Rules, 1957, SEBI Act, 1992, rules, bye-laws and regulations of NSE and BSE, and regulations and guidelines issued by SEBI under the SEBI Act, 1992, Depositories Act, 1996 and Bye-laws & Operating Instructions of the depositories. These are public and readily accessible to system participants.

The Depositories Act, 1996, SEBI (Depositories and Participants) Regulations, 1996, and Bye-Laws and Business Rules of the Central Securities Depositories (CSDs) contain various provisions for facilitating dematerialisation and transfer of securities. SEBI Regulations provide for the regulatory requirements and procedure for dematerialisation and transfer of securities. The bye-laws and business rules of the depositories provide the operating guidelines and procedures in this regard.

With a screen-based on-line trading system, trades between direct market participants are confirmed online at the time of trade. The use of an electronic trading system obviates the need for direct market participants to confirm the terms of the trade. The trades are settled on a rolling basis of T+2 days settlement cycle.

CCPs provide full novation[124] and guaranteed settlement, eliminating counterparty risk entirely. On a T+2 cycle, all scrips are electronically cleared fully through a CCP on a rolling settlement. The dynamic and comprehensive risk management system comprises capital adequacy norms, trading and exposure limits, index-based market-wide circuit breakers and margin (mark-to-market) requirements. The encashability of underlying of margins, comprising cash, bank guarantees and securities is evaluated periodically. The real-time monitoring of broker positions, margins and automatic disablement of terminals with VaR margining has reduced the operational risk. A Trade Settlement Guarantee Fund has been set up to ensure settlement of transactions. Investor and Customer Protection Funds are maintained by stock exchanges to compensate investors in case of default by a member of the exchange. In addition, an Integrated Market Surveillance System (IMSS) has been put up in place by SEBI across the exchanges (BSE and NSE) and depositories (NSDL and CDSL) to monitor exposures across market segments (cash and derivatives) with effect from December 2006.

The Clearing Corporation and CSDs in India are different entities. CSDs do not extend credit or operate settlement systems in India; the settlements are carried out by the CCP. The CCP ensures DvP for its direct participants (clearing members). The Clearing Corporation acts as a CCP for all netted transactions and effects pay-out of securities on receipt of funds. The CSD processes and completes transfer of securities to the receiving members account only upon receipt of instructions from the CCP. The timing of settlement is clearly defined for transactions within the CSD as well as for transactions over a link to another CSD, *i.e.,* between NSDL and CDSL. Transfers by CSD are done at designated times during the day based on instructions from the CCP.

All settlements once carried out are final and there can be no revocation of transfers at any stage. The exchanges and CCPs have well-maintained back-up systems which ensure recovery of transaction information. The CCP has

[124] 'Novation' is a term used in contract law and business law to describe the act of either replacing an obligation to perform with a new obligation, or replacing a party to an agreement with a new party.

well-maintained back-up facilities pertaining to trading, clearing and settlement and a contingency plan for timely recovery of data.

Custodians holding customer securities are required to be registered with SEBI and follow the rules and regulations specified by SEBI for protecting customer securities. Participants' operations are subject to periodic inspection by the CSD and SEBI. Internal and external auditors as well as regulators conduct regular audit inspection of the collateral deposits.

SEBI has taken measures to rationalise account opening charges, custody charges and transaction charges through a committee which compared costs across jurisdictions. There are no charges levied by the CCPs for carrying out basic settlement activities. The charge structure is reviewed regularly by the CSD, taking into consideration the movement in the volume of transactions and costs of operations, and the benefits of increase in the volumes by way of reduction in the fee structure is regularly passed on to the users of the CSD system.

CSDs and CCPs notify their market participants about various operational, systemic requirements, rules regarding risk management and other relevant rules, regulations and procedures by way of circulars and other announcements/publications in electronic as well as hard copy in English. All policy-related circulars, rules and regulations are displayed on the websites of CSDs and CCPs. The rules, regulations and circulars are regularly updated by CCPs on their websites.

CCPs' operations are governed by the provisions contained in the Companies Act, 1956, SEBI Act, 1992, SCRA, 1956, Depositories Act, 1996 and Income-tax Act and the Rules, Regulations, bye-laws, notifications, circulars and directives issued thereunder.

The Securities Settlement System for equities and derivatives market is compliant with the CPSS-IOSCO Recommendations for Securities Settlement Systems. Of the 19 Recommendations, 17 have been assessed as 'Observed', one Recommendation is 'Broadly Observed', which pertains to the securities borrowing and lending, and one is 'Not Applicable', pertaining to cross-border trades.

The issues highlighted by the Advisory Panel and the recommendations made by them are summarised below. The CFSA concurs with the recommendations of the Panel.

In the event of a winding-up of a stock-broking company, the rules of Recognised Stock Exchange (RSE) in respect of settlement obligations are applied and collaterals of the failed entity deposited with RSE towards its dues are appropriated in terms of the provisions of the bye-laws of RSE and settled against the claims of the liquidator. Since these transactions are netted, any unwinding of these transactions could lead to a catastrophic situation for the RSE. There is no express bar on the liquidator under the extant insolvency laws or income tax laws to avoid such contracts, and it is debatable whether the bye-laws of the RSE could preclude the applicability of insolvency or priority provisions or provisions which bar fraudulent transfers under substantive laws, such as the provisions of the Companies Act or Income Tax Act. This issue has become more pronounced, especially in light of the recently passed Payment and Settlement Systems Act, 2007 which specifically provides for legal recognition to the netting procedure and settlement finality by provisions made in the parent Act instead of leaving it to be made through sub-ordinate legislations, such as bye-laws and regulations of RSEs. However, there is hardly any case where the netting or finality of settlement in RSE has been successfully challenged. To put the matter beyond any doubt, it is felt that it may be desirable to incorporate specific clarificatory provisions in the SCRA to provide for the following:

(i) The payment obligations and settlement instructions in respect of securities transactions in RSE/Clearing Corporation among the members or clients may be determined in accordance with netting (or gross) procedure, as may be approved by SEBI;

(ii) Such netting procedure shall have effect notwithstanding anything to the contrary contained in any other law;

(iii) A settlement effected under such a procedure shall be final and irrevocable;

(iv) Where a member of RSE or Clearing Corporation is declared as insolvent or is dissolved or wound-up then, notwithstanding anything contained in any other law, the order of adjudication or dissolution or winding-up shall not affect any settlement that has become final and irrevocable and the right of the RSE or Clearing Corporation to appropriate any collaterals or deposits or margins contributed by the member or client towards its settlement or other obligations in accordance with bye-laws of RSE/Clearing Corporation; and

(v) Settlement, whether net or gross, shall be final and irrevocable as soon as the money, securities, or derivatives or other transactions payable as a result of such settlement is determined, whether or not such money, securities, or derivatives or other transactions is actually paid.

**5.7.23 Assessment of Adherence to CPSS-IOSCO Recommendations for Central Counterparties**

The Advisory Panel observed that in India, there is one CCP which operates in the money market, government securities market and the foreign

exchange market, namely, the CCIL. In the equity market, NSCCL functions as the CCP in the case of NSE and in the case of BSE, the exchange itself serves as the CCP.

**Clearing Corporation of India Limited**

Multilateral netting arrangements using CCPs have gained prominence in settlement of trades in securities, foreign exchange and derivative instruments. In India, CCIL, set up in April 2001, serves as a CCP for trades in the government securities market, the foreign exchange market and CBLO (Collateralised Borrowing and Lending Obligation), a money market instrument. The Reserve Bank took the initiative of setting up CCIL with some of the major banks as its core promoters to upgrade the country's financial infrastructure in respect of clearing and settlement of debt instruments and foreign exchange transactions. CCIL currently provides guaranteed settlement facility for government securities clearing, clearing of CBLO and foreign exchange clearing.

*Government Securities Segment*

CCIL has played the role of a CCP and provided a settlement guarantee mechanism to the government securities settlement system with transactions now being settled on a net basis (DvP III), both in funds and securities legs. Members have the opportunity to trade on the Reserve Bank's Negotiated Dealing System (NDS) or NDS-Order Matching (NDS-OM) system. Settlement through CCIL provides members with assurance of settlement on the settlement date, reduction in counterparty exposure, operational efficiency and improved liquidity. There are now 149 members in the secondary settlement system, with a daily average turnover of about Rs.18,000 crore.

*CBLO Segment*

There are now 149 members in the secondary settlement system of CCIL, with a daily average turnover of about Rs.18,000 crore.

CBLO is a money market product launched on January 20, 2003 by CCIL in order to provide an avenue for the funds deployment of entities that have been phased out from the uncollateralised inter-bank call money market. Borrowing and lending takes place through an electronic anonymous order matching platform. CBLO operates in an Straight-through Processing (STP)-enabled environment, seamlessly encompassing dealing to settlement. CCIL provides guaranteed settlement facility for trades in this instrument as a CCP. The funds leg of the trades in this instrument is settled in the current account maintained by these entities with the Reserve Bank. There are now 173 members in the CBLO segment system with a daily average turnover of about

Rs.27,000 crore. The CBLO market has now become the preferred option for participants in the money market. The volume in this market is now significantly higher than the combined volumes in the call and repo markets.

*Foreign Exchange Segment*

CCIL provides guaranteed settlement facility for all US dollar–Indian Rupee inter-bank Cash, Tom, Spot and Forward transactions. The matched and accepted forwards deals are guaranteed for settlement from S–2 day (two days previous to settlement) and the Spot, Tom and Cash deals are guaranteed for settlement from the trade date as the CCIL becomes the CCP to every accepted trade through the process of novation. The rupee leg of the transactions is settled through the member's current account with the Reserve Bank and the US dollar leg through CCIL's account with the settlement bank at New York. There are now 72 members in the foreign exchange market with a daily average trade value of US$ 15.5 billion. CCIL also provides Continuous Linked Settlement (CLS)[125] services for banks in India by availing of the third-party services of a settlement bank. Banks participating in this segment of CCIL report their cross-currency trades to the settlement bank directly or through CCIL. The settlement is made through the nostro accounts of CCIL with the settlement bank in CLS currencies (of 17 CLS currencies, CCIL provides services in 14 currencies). Settlement of foreign exchange transactions by CCIL has resulted in a reduction in counterparty exposure, increased operational efficiency and lowered overall operational costs. Foreign exchange settlement volumes in CCIL have been rising consistently through the years and have witnessed substantial growth since it commenced operations (Table 5.5).

Mr. Greg Johnston, the peer reviewer, has mentioned that the clearing and settlement of foreign exchange trades through a CCP is not routinely observed in other countries. In most instances, these transactions are settled directly between trade counterparties, and their correspondent banks, using high value payment systems that comply with the Core Principles. The size of the foreign exchange market in developed economies is usually significantly larger than debt securities and equity market. Apart from the size of foreign exchange transactions, settling participants can also be exposed to foreign exchange settlement risk. These characteristics can generate significant

**Table 5.5: Volume of Transactions in Foreign Exchange Market**

| Financial Year | No. of trades settled | Gross Foreign Exchange Settlement Volumes (US $ bn) |
|---|---:|---:|
| 2002-03 | 2,00,464 | 136.10 |
| 2003-04 | 6,61,034 | 501.34 |
| 2004-05 | 9,32,654 | 899.78 |
| 2005-06 | 9,79,298 | 1179.68 |
| 2006-07 | 12,13,616 | 1776.98 |
| 2007-08 | 15,14,148 | 3133.66 |

Source: CCIL.

The CBLO market has now become the preferred option for participants in the money market.

[125] Continuous Linked Settlement settles both sides of a foreign exchange deal simultaneously, thus eliminating risk. The settlement is final and irrevocable.

challenges for a CCP's risk management arrangements, which would need to be carefully assessed.

The Advisory Panel noted that CCIL broadly complies with the CPSS-IOSCO Recommendations for CCPs. Of the 15 Recommendations, six have been assessed by the Panel as 'Observed', six have been assessed as 'Broadly Observed' which pertain to measurement and management of credit exposure, default procedure, money settlement, efficiency and transparency, one Recommendation is 'Partly Observed', *viz.*, inadequacy of financial resources with CCIL and two are 'Not Applicable'. A summary assessment of CCIL is provided in Table 5.6.

The issues addressed by the Panel on Institutions and Market Structure and related recommendations are covered below. Certain related aspects that were addressed by the Panel on Financial Stability Assessment and Stress Testing and the Panel on Financial Regulation and Supervision are also covered under the appropriate heads.

*Measurement and Management of Credit Exposures*

There is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades for the CBLO and foreign exchange segments. CCIL may endeavour to develop capacity to

**Table 5.6: Summary Assessment – Recommendations for Central Counterparties – CCIL**

| Recommendation | | Assessment |
|---|---|---|
| 1. | Legal risk | O |
| 2. | Participation requirements | O |
| 3. | Measurement and management of credit exposures | BO |
| 4. | Margin requirements | BO |
| 5. | Financial Resources | PO |
| 6. | Default procedures | BO |
| 7. | Custody and investment risks | O |
| 8. | Operational risk | O |
| 9. | Money settlements | BO |
| 10. | Physical deliveries | NA |
| 11. | Risks in links between CCPs | NA |
| 12. | Efficiency | BO |
| 13. | Governance | O |
| 14. | Transparency | BO |
| 15. | Regulation and oversight | O |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

measure intra-day exposure and margin requirement (based on intra-day exposures) for government securities, CBLO and foreign exchange segments.

*Margin Requirements*

Under the recommendations for SSS, if a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly. CCPs need to validate that the models and parameters used to determine the margin levels are consistent with the intended coverage, and that the same are reviewed and validated frequently.

In the CBLO segment, CCIL accepts the Central Government's dated securities, T-bills and funds in Indian Rupees as collaterals. The borrowing limit for members is fixed everyday after marking to market and applying appropriate hair-cuts on the securities deposited in the SGL account. The post hair-cut mark-to-market value after adjusting for the amounts already borrowed by the members is the borrowing limit, which, in effect, denotes the drawing power up to which the members can borrow funds. Members are required to deposit an initial margin generally in the form of cash/ Government Securities and the initial margin is computed at the rate of 0.50 per cent of the total amount borrowed/lent by the members. Intended coverage of margin requirements is at 1000 days data VaR (99 per cent confidence level) of the anticipated price change for a 3-day holding period.

Back-testing for CBLO is necessary in order to assess the associated risks as well as adequacy of margins. However, back-testing model is not in place for the CBLO segment. In the CBLO segment, CCIL needs to develop a model for back-testing for margining to ascertain the adequacy of margins collected.

*Adequacy of Financial Resources*

As part of its operations, CCIL also encounters intra-day shortfalls. To tide over the intra-day requirement, CCIL has availed of dedicated Lines of Credit (LoC) from a few commercial banks. The LoC for securities and the foreign exchange segment is Rs.700 crore and for CBLO, a separate LoC is available for Rs.600 crore. The CFSA notes that the LoCs are being further enhanced to Rs.1,600 crore. The CCIL is also in the process of putting in place the concept of clearing member, under which the settlements will be done only in the books of a few members in which case the liquidity requirement in CCIL would come down.

It has been observed that, on certain occasions, the largest exposures to some participants exceeded the amount of liquid financial resources available with CCIL, particularly in the government securities and CBLO segments. CCIL's risk management has been audited by several experts from the banking industry, including the European Central Bank and the Bank of France, and by a team of experts from the Indian Institute of Management, all of whom found the risk processes satisfactory.

Given the significant increase in the volumes of trades in the debt, money and foreign exchange markets, and as the settlements at CCIL effectively take place at the end of the day, it would be difficult for them to raise liquidity from commercial banks equivalent to international benchmarks.

The Panels on Institutions and Market Structure and Financial Stability Assessment and Stress Testing noted that given the significant increase in the volumes of trades in the debt, money and foreign exchange markets, and as the settlements at CCIL effectively take place at the end of the day, it would be difficult for them to raise liquidity from commercial banks equivalent to international benchmarks. Moreover, the cost of any new LoC for CCIL from banks is expected to be significantly higher, which may also lead to an increase in transaction costs. While both Panels recognise that CCIL needs to have adequate financial resources to address liquidity concerns, both have recommended the following options to deal with the situation:

1. CCIL may be granted a Limited Purpose Banking license, so that it can approach the Reserve Bank or the market for liquidity by repo arrangements.
2. CCIL can settle through continuous settlement on the RTGS. This would require that CCIL is granted full membership of RTGS.
3. Intra-day credit provision by the Reserve Bank.

Granting a limited purpose banking license will enable CCIL to approach a repo window.

The CFSA notes that currently all SGL account-holders are mandated by the Reserve Bank to settle their transactions in government securities through CCIL. Also, over time, CCIL has become the major CCP for foreign exchange transactions. This has benefited CCIL inasmuch as it has increased its business and profits. Concomitant with the increase in the business, the liquidity requirement of CCIL has also increased. Granting a limited purpose banking licence will enable CCIL to approach the repo window of another bank to fulfill the requirement of additional liquidity when needed. The CFSA notes that currently the Reserve Bank does not have a policy on issuing differentiated bank licenses. However, as pointed out by the Panel on Financial Stability Assessment and Stress Testing, it has been announced in the Reserve Bank's Annual Policy Statement for 2007-08 that the Reserve Bank will prepare an appropriate policy framework in this regard. In this context, it has been pointed out in the technical paper, 'Differentiated Bank Licences', that the BR Act, 1949 does not provide for differentiated bank licences. The CFSA feels that appropriate amendments in the legal provisions can be considered, making it easier to go ahead with issuing differentiated bank licences for this purpose. The other two options as suggested by the Panels can also be examined.

Appropriate amendments in the legal provisions can be considered, making it easier to go ahead with issuing differentiated bank licences.

The Advisory Panel on Financial Regulation and Supervision has recommended constituting a Working Group to look into the entire gamut of

liquidity support by the Reserve Bank in the context of extraordinary situations that impact the stability of the financial and payment systems. Since CCIL would be granted authorisation to operate under the Payment and Settlement Systems Act, 2007 the issue of the Reserve Bank's liquidity support to CCIL could also form part of the terms of reference of the suggested Working Group. While the CFSA does not favour the idea of a Working Group, issues relating to liquidity infrastructure are separately addressed under Section 5.3.

*Stress Testing*

CCIL needs to develop stress testing models for the CBLO segment. Further, in the foreign exchange segment, CCIL may evolve a clear and transparent policy to ensure that prompt action (regarding calling for additional resources and the time and manner of collection) is taken in cases when stress tests indicate that resources are inadequate. In this regard, the Panel on Institutions and Market Structure has recommended that, as in the case of the foreign exchange market, net debit cap can be fixed for the exposure of CCIL in the government securities segment and CBLO segment. This would ensure that exposure of any single entity would not go beyond the liquidity available with CCIL. The peer reviewer, Mr. Greg Johnston, has also highlighted the need for CCIL to stress-test the adequacy of the total value of resources available to it (*e.g.*, margins, other contributions by members, its own capital and, perhaps, loss-sharing), and establish a clear and transparent framework within which these resources can be increased in the event that stress-test outcomes indicate that existing resources are inadequate. He also has supported the recommendation that the CCIL should be able to impose a cap on the aggregate exposure it takes against its members, as well as member credit limits for each transaction category novated to it. While the CFSA endorses the view of the Panel in principle, in view of the quantum increase in the volumes of trades in the government securities market and since banks are mandated to operate through CCIL, implementation of this should duly consider that it does not hamper smooth trade and settlement operations in the government securities market.

*Default Procedures*

The contract between CCP and its members is one single agreement and all transactions are governed by such a master agreement and all transactions constitute a single agreement between the parties. Though cherry-picking by a liquidator is possible in India, Indian Courts may still regard this as a valid contract since the liquidator cannot take the benefit of a contract without its burden. Even though legal assurance after the notification of the Payment and Settlement Systems Act has put the default handling authority on a comprehensive legal footing in the CBLO and foreign exchange segments, CCIL needs to evolve an objective policy on the modalities of liquidating the default position to reinforce the established default procedure for both CBLO and foreign exchange segments.

Detailed processes for monitoring settlement bank exposures are not in place in CCIL.

*Money Settlements*

Detailed processes for monitoring exposures are not in place. CCIL may develop processes for monitoring settlement bank risk for the CBLO and foreign exchange segments.

*Transparency*

Stress test methodology and the results of stress tests done by the CCIL are not disclosed to the members/public. CCIL may consider making public their stress test methodology and, if feasible, also the results. Further, they may endeavour to provide public information in local languages, apart from English.

*Concentration Risk*

The Panel on Financial Stability Assessment and Stress Testing observed that the role of CCIL as the only CCP catering to the money, securities and foreign exchange markets can lead to concentration risk. Moreover, inadequate lines of credit to ensure liquidity for carrying out settlement is potentially risk-prone. In addition to the possible moral hazard that the CCP might become a case of 'too big to fail', the undue concentration can have systemic implications. It is also observed that there is considerable overlap between the major stakeholders of CCIL and LoC/securities LoC providers, which could lead to conflicts of interest. However, the Panel feels that under the present market structure this is inevitable.

The role of CCIL as the only CCP catering to the money, securities and foreign exchange markets can lead to concentration risk.

A BIS paper on central bank oversight over payment and settlement systems[126] mentions that payment and settlement systems typically exhibit economies of scale; they have high fixed costs (costs independent of the number of transactions processed) and marginal costs that are very low as the number of transactions processed increases. In such an environment, concentration among a few large-scale providers, or even a natural monopoly, may be the most efficient market structure. Significant market concentration, however, may lead to a high dependency on a few key payment and settlement systems without, by definition, readily available alternatives. Moreover, market concentration may be significant enough to give payment and settlement providers market power that leads them to provide lower levels of services at higher prices, lower investment in risk reduction and perhaps a lower level of innovation than is socially optimal. The increasing importance of oversight by the central bank reflects the increasing

[126] Bank for International Settlements (2005): *Central Bank Oversight over Payment and Settlement Systems*, May.

sophistication, complexity and concentration of many systems and the very large increases in the values of transfers through them. This growth in values and concentration together raises concerns that significant systemic risk could arise if the design and operation of systems is inadequate.

In this context, the CFSA recognises that concentration of business with CCIL pertaining to government securities, money and foreign exchange markets helps them to pool the risks and reduce the overall transaction costs for the system. The CFSA, however, concurs with the Panel and feels that the risk management systems in CCIL should be further strengthened. Also, the capital and liquidity needs of CCIL could be addressed so that the propensity of failure of this entity, which could have systemic implications, can be prevented.

CFSA notes that CCIL which has paid-up equity of Rs.50 crore has increased its capital by way of issue of preference share capital (Rs.50 crore as of March 31, 2008), thereby making the total paid-up capital Rs.100 crore. CCIL has also built over a period of time Rs.207 crore worth of reserves (as of September 30, 2008). Accordingly, it has a total net worth of Rs.307 crore as of September 30, 2008.

***National Securities Clearing Corporation Ltd (NSCCL) and Bank of India Shareholding Limited (BOISL)***

The National Securities Clearing Corporation Ltd. (NSCCL), a wholly-owned subsidiary of NSE, was incorporated in August 1995 and commenced operation as a clearing corporation in April 1996. NSCCL functions as a CCP and clears and settles operations in the case of the NSE; in the case of BSE, the exchange itself serves as the CCP.

The settlement of trade in the equity market (both cash and derivative segments) is settled in the BSE by Clearing House, Bank of India Shareholding Ltd (BOISL) which is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). On the other hand, clearing and settlement operations of the NSE are managed by its wholly-owned subsidiary, NSCCL, which is also known as Clearing Corporation (CC). All other stock exchanges use clearing houses to clear and settle trade; however, there are either no transactions on these exchanges or transactions are negligible.

The area of clearing and settlement has witnessed substantial progress in the Indian securities market over the past decade as a result of various reforms initiated by the regulatory authorities. Implementation of advanced information technology at every stage has played a crucial role in the entire process. Some key developments in this regard are mentioned below:

- Screen-based trading
- Dematerialisation and electronic transfer of securities
- Introduction of rolling settlement
- Compression of settlement cycle to T+2

The risk management systems in CCIL should be further strengthened.

- Multilateral netting
- Delivery versus payment
- Robust risk management
- Emergence of clearing corporation to assume counterparty risk
- Real Time Gross Settlement/Electronic fund transfer facility
- Limited straight-through processing

The reforms in the securities settlement systems have resulted in:

- Reduction and mitigation of systemic, structural and operational risks;
- Increased speed of transactions, execution and settlement of trade and quicker settlement of transactions with finality;
- Safety of the settlement process; and
- Reduction of transaction costs, thereby making the market more efficient and transparent for investors and participants.

The NSCCL and the BOISL are compliant with the CPSS-IOSCO Recommendations for CCPs. Of the 15 Recommendations, 14 have been assessed as 'Observed' and one as 'Not Applicable'. A summary assessment of NSCCL and BOISL is provided in Table 5.7.

**Table 5.7: Summary Assessment – Recommendations for Central Counterparties – NSCCL & BOISL**

| | Recommendation | Assessment |
|---|---|---|
| 1. | Legal risk | O |
| 2. | Participation requirements | O |
| 3. | Measurement and management of credit exposures | O |
| 4. | Margin requirements | O |
| 5. | Financial resources | O |
| 6. | Default procedures | O |
| 7. | Custody and investment risks | O |
| 8. | Operational risk | O |
| 9. | Money settlements | O |
| 10. | Physical deliveries | O |
| 11. | Risks in links between CCPs | NA |
| 12. | Efficiency | O |
| 13. | Governance | O |
| 14. | Transparency | O |
| 15. | Regulation and oversight | O |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

### 5.7.3 Summary

The smooth functioning of the payment and settlement systems is a pre-requisite for the stability of the financial system. In order to have focused attention on payment and settlement systems, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) was set up in March 2005. Concomitant with the growth of the economy, there has been a significant increase in both the volume and value of transactions through SIPS. The launch of the RTGS has led to a reduction of settlement risk in large-value payments in the country. The setting up of NSDL and CDSL for the capital market settlements and CCIL for government securities, foreign exchange and money market settlements have improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems have been carried out. The Payment and Settlement Systems Act, 2007 has recently come into effect with the regulations under it having been notified.

The following measures have been suggested to further strengthen the efficiency of payment and settlement systems:

(i) Shifting high-value transactions to a more secure electronic payment system, like RTGS.

(ii) Combating credit card fraud.

(iii) Steps may be taken to optimise the utilisation of the electronic payments infrastructure and reduce the charges for such transactions.

(iv) Telecom system providers would play a growing role as payment system facilitators particularly through mobile phones. However, adequate steps need to be taken to ensure safety and security in a mobile-based computing/communicating environment.

*Clearing Corporation of India Ltd.*

CCIL serves as the CCP for trades in the government securities market, foreign exchange market and CBLO (Collateralised Borrowing and Lending Obligation), which is a money market instrument. CCIL's risk management systems have been audited by several experts from the banking industry, including the European Central Bank and the Bank of France, and by a team of experts from the Indian Institute of Management, all of whom found the risk processes satisfactory. Concomitant with the increase in the business over time, the liquidity requirement of CCIL has also increased. The grant of a limited purpose banking license could enable CCIL to approach the repo window of another bank to fulfill the requirement of additional liquidity, when needed.

*Concentration Risk*

The role of CCIL as the only CCP catering to money, securities and foreign exchange markets leads to concentration risk. Though concentration of business with CCIL helps pool the risks and reduce the overall transaction

The launch of the Real Time Gross Settlement System (RTGS) has led to a reduction of settlement risk in large-value payments in the country.

costs for the system, the risk management systems in CCIL should be further strengthened. From this angle, addressing the capital and liquidity needs of CCIL could be considered so that the propensity of the failure of this entity, which could have systemic implications, can be prevented.

*Retail Payment Systems*

Retail payment systems in India, though not systemically important, assume significance based on the sheer number of users of various payment channels. Though there has been significant improvement in retail payment systems through the introduction of new facilities like ECS, EFT and RTGS, these have not trickled down to the lower end of the customer segment. The solution will be to expand the network connectivity of branches in rural and semi-urban areas, so that customers in these areas can utilise the electronic payment infrastructure. There is a need to develop solutions using newer technologies that allow all segments of society to gain access to the benefits offered by these facilities. The current low utilisation of the electronic payments infrastructure should be increased through the use of technology to make the facilities more accessible to customers. Enabling usage of these facilities on mobile devices, which have high penetration levels and low transaction costs, could result in a large portion of the population gaining access to these facilities. The CFSA notes that the Reserve Bank issued operating guidelines on mobile payments in India in October 2008.

## 5.8 Legal Infrastructure

*Legal Framework*

The legal framework governing the regulation and supervision of financial systems in the country, as well as the various laws which may have a bearing on the stability of the financial sector, have gained considerable importance in recent times. The legislative process in India is complex and often requires elements of economic reform and underlying legislative framework to be harmonised. At the same time, experience shows that it may often not be necessary to wait for the legislative framework to change to bring about some of the reforms or to initiate processes to demonstrate the usefulness of reform-orientation. Reforms may also be managed within the constraints of law without recalling/amending the same and this option needs to be explored since changes in law are often difficult to get through in a democratic process. There are some enabling, but not mandated, provisions which may or may not be used.

Often, it may not be necessary to wait for the legislative framework to change in order to bring about some of the reforms.

The financial sector reforms undertaken since the 1990s have led to amendments to various Acts with the intent of giving greater flexibility to the

Reserve Bank. Further, amendments have been carried out in the Bank Nationalisation Act, SBI (Subsidiary Banks) Act, 1959, to incorporate legal provisions on 'fit and proper' criteria along the lines of the provisions relating to private sector banks. Even though several provisions already exist in the BR Act from the corporate governance angle, to supplement such provisions further, the Reserve Bank, in the exercise of its delegated legislative powers under Section 35A of the BR Act, has issued directions to banking companies to undertake a process of due diligence to determine the suitability of the person for appointment/continuing to hold appointment as a director on their Board, based on qualifications, expertise, track record, integrity and other fit and proper criteria.

Likewise, another area with an important bearing on financial stability is the mechanism of amalgamation provided under Section 45 of the BR Act. In cases of bank failures in the recent past, the process of amalgamation of such banks, through invoking the provisions of Section 45 of the BR Act, were initiated immediately by the Reserve Bank and the Central Government and the interests of the depositors were safeguarded under the schemes of amalgamation. It has also been possible to reduce drastically the period of moratorium imposed on the failed banks, thus minimising the inconvenience to depositors.

The Panel on Financial Stability and Stress Testing noted that there are several pending amendments in the relevant laws relating to the financial sector which are expected to have a bearing on the stability of the financial sector. The amendments pending consideration by Parliament relate to enabling banking companies to raise capital by the issue of preference shares subject to regulatory guidelines by the Reserve Bank; removing the restrictions on voting rights and providing for the Reserve Bank's prior approval for acquisition of 5 per cent or more of shares or voting rights in a banking company by any person, and empowering the Reserve Bank to impose such conditions as it deems fit in this regard, in order to satisfy itself that the acquisition of shares of a banking company is by a 'fit and proper' person; empowering the Reserve Bank to supersede the Board of Directors of a bank and appoint an administrator to manage the bank until alternate arrangements are made; and insertion of Section 29A empowering the Reserve Bank to call for information and returns from the associate enterprises of banking companies also and inspect them, if necessary.

*Legal Infrastructure Governing Institutions*

The issue relating to dual control in the case of co-operative banks can often hinder the resolution of issues that arise when co-operative banks fail, especially since the Reserve Bank's powers are confined up to the stage of imposition of a moratorium on a failed co-operative bank and, insofar as the process of amalgamation thereafter is concerned, the powers are vested in the concerned authorities of the respective State Governments. The task of resolution becomes more difficult because the Co-operative Societies Acts of

There are several amendments pending consideration by Parliament.

the respective States permit amalgamation of a co-operative bank only with another co-operative bank and not with any other entity. In actual practice, when co-operative banks are in financial difficulties, quite often they are placed under directions issued by the Reserve Bank that impose limitations on incurring liabilities and making payments, including repayment of deposits. While depositors are denied access to their deposits beyond a small limit during the pendency of such directions, which normally lasts for a few years, the insurance protection under the DICGC Act is also not available to them during this period. Further, the Co-operative Societies Acts prevailing in certain States are not in conformity with the provisions of the DICGC Act for availing the deposit insurance cover. Given the delay in regulatory resolution of problem banks leading to delay in settlement of deposit insurance claims in case of bank liquidation, a recent order passed by the National Consumer Commission has stated that there is a need to delink the DICGC claims settlement process from liquidation.

In the case of the Recovery of Debts due to Banks and Financial Institutions (RDDBFI) Act, 1993 the provisions of the Act have been made applicable to debts of more than Rs.10 lakh. However, the Central Government has been given the power to make this Act applicable to debts of any amount not less than Rs.1 lakh, which the Central Government may specify. Delay in the recovery proceedings before DRTs result in huge amounts of public money being locked up, which prevents its proper utilisation and recycling; therefore, the issue of delay in the recovery process before the DRT/DRAT needs to be addressed by increasing the number of DRTs/DRATs. With the introduction of the SARFAESI Act, banks and FIs are opting to enforce their security interest without the intervention of the Court under the provisions of that Act and approaching DRTs only for the balance due. Consequently, it is expected that the workload of DRTs may come down, which would justify the reduction of the Rs.10 lakh limit to Rs.1 lakh under the DRT Act.

Delay in the recovery proceedings before DRTs result in huge amounts of public money being locked up.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), effective from the date of promulgation of the first Ordinance, *i.e.,* June 21, 2002 has been extended to cover co-operative banks by a notification dated January 28, 2003. The Enforcement of Security Interest and Recovery Debts Laws (Amendment) Act, 2004 has amended the SARFAESI Act, Recovery of Debts due to banks and financial institutions Act, 1993 and the Companies Act, 1956. By this amendment, the SARFAESI Act has been amended, inter alia, to (a) enable the

borrower to make an application before the debt recovery tribunal against the measures taken by the secured creditor without depositing any portion of the money due; (b) provide that the debt recovery tribunal shall dispose of the application as expeditiously as possible within a period of 60 days from the date of application and (c) enable any person aggrieved by the order by the debt recovery tribunal to file an appeal before the debt recovery appellate tribunal after depositing with the appellate tribunal 50 per cent of the amount of debt due to him as claimed by the secured creditor or as determined by the debt recovery tribunal, whichever is less.

SARFAESI Act, 2002 has empowered banks and financial institutions to enforce securities given for the loans and advances by a borrower, without the intervention of the Court. This has helped banks reduce their NPAs. Although the SARFAESI Act provides for setting up a computerised Central Registry for the registration of securitisation, reconstruction and security interest transactions, so far such a Registry has not been set up. Since all transactions creating security interests (covered by the SARFAESI Act) involving amounts not less than Rs.1 lakh will have to be registered with the Central Registry, once set up, it will definitely help lenders assess the quality of the security which has been offered to them by a borrower as collateral. Incidentally, the creation of equitable mortgage over immovable property does not get reflected in the Encumbrance Certificate issued by the Registering Authorities of the State Government as there is no registered deed while creating equitable mortgage, but it is created by the deposit of title deeds. Registration of transactions of creation of security interest by equitable mortgages with the Central Registry would help lenders in situations of fraud, as in several cases unscrupulous borrowers have used copies of the same title deed to obtain loans against the same property from more than one bank. The Panel felt that necessary steps need to be taken for early setting up of the Central Registry.

Banks have recently reported that DRTs grant stay orders when banks propose to sell the securities under Section 13(4) of the SARFAESI Act. The banks have demanded that a statutory provision, similar to a caveat under the Code of Civil Procedure, 1908, wherein the concerned banks/FIs would be heard before granting stay, is required. Given that the SARFAESI Act itself has been enacted to empower banks to enforce their security interest and sell their security without the intervention of the courts, the Panel feels that there is considerable force in the demand made by the banks and a suitable provision may have to be inserted into the SARFAESI Act to safeguard the interests of lenders.

Unscrupulous borrowers have used copies of the same title deed to obtain loans against the same property from more than one bank.

The CFSA feels that the Government may consider the aforesaid suggestions given by the Panel

The Credit Information Companies (Regulation) Act, 2005 is aimed at providing for regulation of credit information companies and to facilitate efficient distribution of credit. The Act provides for establishment, supervision and regulation of credit information companies that can

undertake the functions of collecting, processing and collating information on trade, credit and financial standing of the borrowers of credit institutions which are members of the credit information company. This enactment will now enable the introduction of credit information bureaus in India within a suitable regulatory framework.

*Competition Issues*

The Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 [Section 4(2)] specifically excluded the applicability of that Act to banks in relation to matters in respect of which specific provisions exist in the RBI Act, BR Act, SBI Act or Subsidiary Bank's Act.

The Panel on Financial Stability Assessment and Stress Testing observes that the Competition (Amendment) Act, 2007 which has recently amended various provisions of the Competition Act, 2002 and has replaced the MRTP, raises serious concerns. One area of concern for the financial sector is the powers of the Commission to regulate combinations. Given that consolidation in the financial sector is inevitable, the provisions of the Competition Act are likely to place hurdles in its path. Under the provisions of the Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for a maximum period of 210 days. The wide-ranging powers conferred on the Competition Commission to nullify a combination are a cause for concern for banks and financial institutions. Since voluntary amalgamation of banks under Section 44A of the BR Act, 1949 is at the instance of the concerned banks, it may become necessary for the banks to give notice of a proposal of voluntary amalgamation to the Commission and get the order of the Commission or wait for 210 days; the Reserve Bank may be able to consider giving sanction to the scheme of amalgamation only thereafter. This, apart from delaying the whole process, is also likely to raise regulatory conflicts. The position in the case of acquisition of business of other banks by the SBI or its subsidiaries under Sections 35 and 38, respectively, of the SBI Act, 1955 and the SBI (Subsidiary Banks) Act, 1955 is also not free from doubt. Similarly, a view needs to be taken about the applicability of the aforesaid provisions in the case of compulsory amalgamation under Section 45 of the BR Act and also amalgamations of nationalised banks under the schemes made by the Central Government in exercise of its powers under Section 9(2)(c) of the Nationalisation Acts, 1970/1980. Considering the gravity of the matter and the repercussions, particularly from the angle of financial stability, the Panel felt that it was necessary to

The wide powers conferred on the Competition Commission to nullify a combination are a cause for concern for banks and financial institutions.

seriously examine the entire issue and, if considered necessary, the Central Government should give necessary exemption under Section 54 of the Competition Act.

Though Section 21 A of the Competition Act provides for the Commission to make references to a statutory authority when the issue before it relates to an Act whose implementation is entrusted to that statutory authority, it is observed that the opinion of the statutory authority in such a case has not been given any binding effect on the Commission and the final decision has been left to the Commission. Going by this principle, in respect of matters relating to banks, whose exclusive jurisdiction has been given to the Reserve Bank, it should have been left to the Reserve Bank to take the final decision in such matters and the opinion of the Commission could have been made an input for the Reserve Bank to decide. The Panel observed that the provisions of the Competition Act, as amended, are likely to raise issues of regulatory overlap/conflict in the future and pose a serious problem for the financial sector. The approach adopted by the United Kingdom and the anti-trust law in the US are given in Box 5.8.

**Box 5.8: Competition Issues - Approaches in the UK and the US**

**Competition Commission in the United Kingdom**

In the United Kingdom, a Competition Commission is in place, which is empowered to conduct an inquiry 'into a particular sector of the economy or into particular types of agreements across various sectors' if the trend of trade, the rigidity of prices or other circumstances suggest that competition may be restricted or distorted within the 'common market'. The House of Lords of the UK Parliament appointed a Select Committee on Regulators in 2006 with a broad remit to 'consider the regulatory process' which focused, among other things, on the extent to which the regulators have successfully promoted competition. In respect of whether regulators had a primary statutory duty to promote competition, it was observed that where there was no such primary duty to promote competition, regulators often had secondary duties which required them to consider the impact of their policies and decisions on competition, or at least that they interpreted as such. For example, the FSA did not have the promotion of competition as one of its statutory objectives, but in discharging its general functions, it needed to have regard to the desirability of facilitating competition.

On the question of whether the FSA should gain a primary statutory duty to promote competition, it was suggested that it was preferable to focus on making the FSA's relationship with the existing competition authority (the Office of Fair Trading (OFT)) work, while also ensuring that considerations of competition and international competitiveness were built into the FSA's policy development process. Though the financial services industry was obviously in favour of a new statutory objective for the FSA to promote competition, another view was that there was no need for 'yet another competition authority'. Since a great deal of competition already existed in the financial services sector, it was up to the existing competition authority (OFT) to stop anti-competitive practices.

**Anti-trust law in the US**

The United States anti-trust law is the body of laws that prohibits anti-competitive behaviour (monopoly) and unfair business practices in the US. The anti-trust laws

The provisions of the Competition Act are likely to raise issues of regulatory overlap/conflict in the future and pose a serious problem to the financial sector.

comprise a 'charter of freedom', designed to protect the core values regarding free enterprise in America. The main goal was not to protect consumers, but to prohibit the use of power to control the marketplace. The term 'anti-trust' was originally formulated to combat 'business trusts', now more commonly known as cartels.

These competition laws make illegal certain practices deemed to hurt businesses or consumers or both, or violate standards of ethical behaviour. Government agencies known as competition regulators, along with private litigants, apply the anti-trust and consumer protection laws. A distinction between single-firm and multi-firm conduct is fundamental to the structure of the US anti-trust law. Multi-firm conduct tends to be seen as more likely than single-firm conduct to have an unambiguously negative effect and is judged more sternly. In considering multi-firm conduct, another distinction is the one between conduct that is deemed anti-competitive per se and conduct that may be found to be anti-competitive after a reasoned analysis. The US anti-trust law thus does not attack monopoly power obtained through superior skill, foresight and industry. The following types of activity are often subject to anti-trust scrutiny: price fixing, bid rigging and geographic market allocation. Anti-trust laws prohibit agreements in restraint of trade, monopolisation and attempted monopolisation, anticompetitive mergers and tie-in schemes, and, in some circumstances, price discrimination in the sale of commodities.

The CFSA feels that the Government should consider the views of the Panel.

**Bankruptcy Laws**

*Benchmark*

The time taken for insolvency proceedings in India is one of the highest and the recovery rate one of the lowest in the world.

The 'Principles for Effective Insolvency and Creditor Rights Systems (Revised), 2005' by the World Bank serves as the benchmark for assessing bankruptcy regimes (Box 5.9). Though these principles are yet to be finalised, they have already been used by the World Bank in a series of country assessments. While the World Bank has not finalised any detailed or contemporary standards, the Advisory Panel on Institutions and Market Structure decided, in consultation with the World Bank, to do the assessment of bankruptcy laws in India based on the Revised Principles issued by them in 2005. The Panel also has relied upon the *Handbook on Financial Sector Assessment.* The Panel Report was peer reviewed by Mr. Thomas C. Baxter Jr., General Counsel and Executive Vice-President, Federal Reserve Bank of New York and Shri T.R. Sridharan, former Chairman, Canara Bank. Mr. Baxter and Shri Sridharan complimented the Panel for a comprehensive Report that has also highlighted the major shortfalls in India's insolvency regime. Mr. Baxter stated that India's insolvency regime is an 'enigma' as, despite having well-conceived insolvency laws, the time taken for insolvency proceedings in India

## Box 5.9: Principles for Effective Insolvency and Creditor Rights Systems (Revised) – 2005

*The Principles for Effective Insolvency and Creditor Rights Systems*, (Revised), 2005 issued by the World Bank is an improvement on the Principles of 2001 based on the experience gained by country assessment conducted by the World Bank relying on the earlier principles. Inputs for the revised Principles came from a variety of sources including the UNCITRAL Legislative Guide on Insolvency Law, the Forum on Asian Insolvency Reform, Forum on Insolvency in Latin America and International Association of Insolvency Regulators. The Revised Principles have been categorised into four parts – Part A dealing with Legal Framework for Creditor Rights (consisting of five principles), Part B dealing with Risk Management and Corporate Workout (consisting of five principles), Part C dealing with Legal Framework for Insolvency (consisting of 15 principles) and Part D on the Institutional and Regulatory Frameworks (consisting of eight principles). Each principle is further sub-divided into sub-principles. Following is a brief summary of the key elements of the principles.

**Credit Environment**

***Compatible Credit and Enforcement Systems:*** A regularised system of credit should be supported by mechanisms that provide efficient, transparent and reliable methods for recovering debt, including seizure and sale of immovable and movable assets and sale of collection of intangible assets, such as debt owed to the debtor by third parties.

***Collateral Systems:*** A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system.

***Enforcement Systems:*** A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system.

**Risk Management and Informal Workout Systems**

***Credit Information Systems:*** A modern credit-based economy requires access to complete, accurate and reliable information concerning borrowers' payment histories. This process should take place in a legal environment that provides the framework for the creation and operation of effective credit information systems. Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals.

***Informal Corporate Workout:*** Corporate workouts should be supported by an environment that encourages participants to restore an enterprise to financial viability.

**Insolvency Law Systems**

***Commercial Insolvency:*** Though approaches vary, effective insolvency systems have a number of aims and objectives. Systems should aspire to: (i) integrate with a country's broader legal and commercial systems; (ii) maximise the value of a firm's assets and recoveries by creditors; (iii) provide for both efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors and reorganisation of viable businesses; (iv) strike a careful balance between liquidation and reorganisation, allowing for easy conversion of proceedings from one proceeding to another; (v) provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors; (vi) provide for timely, efficient and impartial resolution of insolvencies;

(vii) prevent the improper use of the insolvency system; (viii) prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments; (ix) provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information; (x) recognise existing creditor rights and respect the priority of claims with a predictable and established process; and (xi) establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

***Implementation: Institutional and Regulatory Framework:*** The institutional framework has three main elements: the institutions responsible for insolvency proceedings, the operational systems through which cases and decisions are processed and the requirements needed to preserve the integrity of these institutions.

**Overarching Considerations of Sound Investment Climates**

***Transparency, Accountability and Corporate Governance:*** Minimum standards of transparency and corporate governance should be established to foster communication and co-operation. Transparency and strong corporate governance are needed in both domestic and cross-border transactions and at all phases of investment.

***Predictability:*** There should be well-defined and predictable risk allocation rules and consistent application of written laws.

is one of the highest and the recovery rate one of the lowest in the world. He added that further study is required to ascertain the reasons for the long pendency of insolvency suits and the poor recovery rates.

The CFSA has summarised the views and recommendations of some of the earlier Committees on the insolvency regime in India.

### 5.8.1 Earlier Committees on Insolvency Laws

A High Level Committee on Law Relating to Insolvency of Companies, 2001 under the Chairmanship of Justice Eradi recommended that the Companies Act, 1956 be amended for setting up a National Company Law Tribunal (NCLT) which will have comprehensive powers such as: (a) the jurisdiction and power presently exercised by the Company Law Board; (b) the power to consider rehabilitation and revival of companies – a mandate presently entrusted to the Board for Industrial and Financial Reconstruction (BIFR)/Appellate Authority for Industrial and Financial Reconstruction under SICA; and (c) the jurisdiction and power relating to winding-up of companies presently vested in the High Courts. The Committee had recommended suitable amendments to the Constitution of India to enable the setting up of a National Tribunal. The Committee further recommended (i) the creation of a

Panel of professional insolvency practitioners (like chartered accountants, company secretaries, and advocates) and their appointment in the liquidation proceedings, (ii) omission of Chapter IV of the Companies Act dealing with 'winding-up subject to the supervision of the Court', (iii) adoption of the UNCITRAL Model Law on Cross-border Insolvency, and (iv) the creation of a rehabilitation fund 'for revival rehabilitation, for preservation and protection' of assets of companies under the supervision and control of the Government.

The Central Government accepted the majority of the recommendations of the Justice Eradi Committee and consequently Parliament passed the Companies (Second Amendment) Act, 2002 that amended the provisions of the Companies Act, 1956 proposing major changes that have a bearing on the rehabilitation and winding-up of a company. A Division Bench of the Madras High Court, however, found certain provisions of the Companies (Second Amendment) Act, 2002 defective and an appeal against the said decision has been pending before the Supreme Court of India since 2004. The Central Government has introduced the Companies Bill, 2008 in Parliament to replace the Companies Act, 1956 for regulation of companies in the country. This Bill also proposes to constitute a NCLT/National Company Law Appellate Tribunal (NCLAT) as the fora for dealing with rehabilitation of companies, their liquidation and winding-up.

The Advisory Group on Bankruptcy Laws (Chairman: Dr. N. L. Mitra) had examined the recommendations of Justice Eradi but its suggestion was for a separate comprehensive bankruptcy code. The Mitra Committee was of the view that separate tribunals are not required and recommended a separate bankruptcy bench in each High Court. It recommended that professionals like chartered accountants, company secretaries and law firms should be empanelled and appointed as trustees to deal with insolvency proceedings. The Group also agreed that the international standards with respect to insolvency, including the UNCITRAL Model Law on Cross-border Insolvency, should be incorporated in Indian laws and recommended time-bound bankruptcy proceedings that give time-frames for each portion of the proceedings.

The Expert Committee on Company Law, 2005 (Chairman: Shri J. J. Irani), while examining the provisions of the new company law, also examined the provisions regarding winding-up and rehabilitation of companies. To facilitate unobstructed conduct of the insolvency process by the Tribunal without having to deal with the complexities of multiple creditor actions in DRTs, the Irani Committee observed that, on an average, a time-frame of two years should be feasible for the liquidation process to be completed and a period of one year should be adequate for the rehabilitation process from commencement of the process until the sanction of a plan. There should also be a definite time-limit within which proceedings may commence from the date of filing of the application for rehabilitation. The Committee further recommended the following: the insolvency process should apply to all enterprises or corporate entities, including small and

medium enterprises, except banks, financial institutions and insurance companies; the insolvency process is to be administered by a qualified administrator (empanelled professional) appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stakeholders; constitution of separate committees for secured and unsecured creditors; appointment of independent experts as valuers for valuation of assets of a business concern under liquidation; public interests and Government claims should not get precedence over private rights in the insolvency process; repeal of the provision relating to a levy of rehabilitation cess by the Government and creation of a fund to which the companies may contribute on their own option and the use of such fund (in the proportion of each company's contribution) when that particular company is in need of rehabilitation; and adoption of the Model Law on Cross-border Insolvency.

### 5.8.2 Assessment by the Panel on Institutions and Market Structure

The Principles issued by the World Bank have been categorised into four parts – Part A deals with Legal Framework for Creditor Rights (consisting of five principles), Part B deals with Risk Management and Corporate Workout (consisting of five principles), Part C deals with Legal Framework for Insolvency (consisting of 15 principles) and Part D with Institutional and Regulatory Frameworks (consisting of eight principles). Each principle is further sub-divided into sub-principles. The term 'insolvency' as used in the Principles and the FSAP Handbook covers both the provisions relating to liquidation as well as restructuring.

The Panel has examined the existing legal framework in respect of each sub-principle, identified the gaps, if any, and made an assessment along with appropriate recommendations to bridge those gaps. The assessment mainly dealt with corporate insolvencies (both liquidation as well as rehabilitation). The Panel has also separately examined under each principle, as relevant, the aspects of liquidation and rehabilitation of banks, NBFCs and insurance companies, as they are a part of the financial system but the framework for dealing with insolvency is different, with the close involvement of regulatory authorities and the Governments.

The Panel has used four grades, namely, 'Observed', 'Broadly Observed', 'Partly Observed' and 'Not Observed' to assess the Indian system based on the applicable Principles. The observance status of the Indian insolvency framework, divided according to major Principles in the four parts, is provided in Table 5.8.

| Table 5.8: Summary Assessment of Effective Insolvency and Creditor Rights Systems | | | | |
|---|---|---|---|---|
| **Principles/Sub-Principles** | **O** | **BO** | **PO** | **T** |
| **A. Legal Framework for Creditor Rights** | | | | |
| A1 Key Elements of Legal Framework for Creditor Rights | – | – | 1 | 1 |
| A2 Security (Immovable Property) | – | 1 | – | 1 |
| A3 Security (Movable Property) | – | 1 | – | 1 |
| A4 Registry Systems | – | 3 | – | 3 |
| A5 Commercial Enforcement Systems | – | 2 | – | 2 |
| **Total – A** | **–** | **7** | **1** | **8** |
| **B. Risk Management and Corporate Workout** | | | | |
| B1 Credit Information Systems | 5 | – | – | 5 |
| B2 Director and Officer Accountability | 1 | – | – | 1 |
| B3 Legislative Framework enabling Workouts | 4 | 2 | – | 6 |
| B4 Informal Workout Procedures | 3 | – | – | 3 |
| B5 Regulation of Workouts and Risk Management Practices | 2 | – | – | 2 |
| **Total – B** | **15** | **2** | **–** | **17** |
| **C. Legal Framework for Insolvency** | | | | |
| C1 Key Objectives and Policies | – | 1 | – | 1 |
| C2 Due Process: Notification and Information | 2 | 1 | – | 3 |
| C3 Eligibility | – | – | 1 | 1 |
| C4 Applicablility and Accessibility | 2 | – | 2 | 4 |
| C5 Provisional Measures and Effects of Commencement | – | 2 | 1 | 3 |
| C6 Management | 2 | – | – | 2 |
| C7 Creditors and Creditors' Committee | – | – | 2 | 2 |
| C8 Collection, Preservation, Administration and Disposition of Assets | 1 | 1 | 1 | 3 |
| C9 Stabilising and Sustaining Business Operations | 1 | 1 | – | 2 |
| C10 Treatment of Contractual Obligations | 2 | – | 2 | 4 |
| C11 Avoidable Transactions | 3 | – | – | 3 |
| C12 Claims and Claims Resolution Procedures | 3 | 1 | 1 | 5 |
| C13 Claims Filing and Resolution | – | 1 | – | 1 |
| C14 Re-organisation Proceedings | 2 | 3 | 1 | 6 |
| C15 International Consideration | – | 1 | – | 1 |
| **Total – C** | **18** | **12** | **11** | **41** |
| **D. Institutional and Regulatory Frameworks** | | | | |
| D1 Role of Courts | – | 1 | – | 1 |
| D2 Judicial Selection, Qualification, Training and Performance | – | 1 | – | 1 |
| D3 Court Organisation | 1 | – | – | 1 |
| D4 Transparency and Accountability | 1 | – | – | 1 |
| D5 Decision-making and Enforcement of Orders | 1 | – | – | 1 |
| D6 Integrity of System – Court and Participants | 1 | – | – | 1 |
| D7 Role of Regulatory or Supervisory Bodies | – | 1 | – | 1 |
| D8 Competence and Integrity of Insolvency Representatives | 1 | – | – | 1 |
| **Total – D** | **5** | **3** | **–** | **8** |
| **Grand Total (A+B+C+D)** | **38** | **24** | **12** | **74** |

O – Observed; PO – Partly Observed; BO – Broadly Observed; T – Total.

The following important observations emerge from the assessment;

- Overall, the observance status shows a great deal of compliance, with 62 of the 74 Principles being either 'Observed' or 'Broadly Observed'.
- The remaining 12 principles which are 'Partly Observed' mainly belong to the category of legal framework for insolvency and creditor rights, highlighting the need to strengthen the legal framework in this respect.

The regulator is in a better position to initiate bank insolvency proceedings.

The problems pertain specifically to provisional measures and effects of commencement of insolvency proceedings, governance and administration of insolvency proceedings and claims and their resolution.

The CFSA deals first with the insolvency law framework relating to financial institutions before covering the major observations and recommendations pertaining to the insolvency regime as a whole.

### 5.8.3 Insolvency Law Framework for Banks

Both the Mitra Committee and the Irani Committee have recognised that the insolvency process as applicable to the general corporate sector should not be made applicable to banks, financial institutions and insurance companies. The World Bank Principles also recognise the need for giving a separate dispensation to financial institutions and insurance companies. The FSAP Handbook recognises two types of bankruptcy regimes, *viz.*, (i) bank insolvency regime and (ii) general corporate insolvency regime. The FSAP Handbook suggests that the legal mandates and functions of each of the official agencies and authorities involved in the resolution of insolvent banks, such as (a) the central bank, (b) the supervisory agency, (c) the deposit insurance agency and (d) the Ministry of Finance, should be clearly delineated in a manner that avoids gaps or overlap and the independence of the supervisory authority (regulator) has been particularly emphasised. Also, there should be strong anti-trust conditions to prevent excessive concentration in the financial sector. The regulator is in a better position to initiate bank insolvency proceedings for two reasons: (i) on account of the systemic implications of a bank's insolvency and (ii) to prohibit the initiation of proceedings by frivolous/malicious creditors against solvent banks. Laws should also grant legal protection for bank supervisors and their staff members to fulfill their responsibilities, and should require banking supervisors to be transparent (without compromising confidentiality, wherever it is required) while implementing bank insolvency.

The peer reviewer, Mr. Thomas C. Baxter Jr., has also stated that a special insolvency regime for banks is seen to complement access to the credit facilities of the central bank and deposit insurance as features unique to the bank charter.

The CFSA believes that a separate insolvency regime for banks and other financial institutions is vital in the context of financial stability.

The CFSA believes that a separate insolvency regime for banks and other financial institutions is vital in the context of financial stability. Any abrupt handling of insolvency of such institutions will have serious contagion

effect and repercussions across the economic system that would destabilise economic activity.

*Legal Framework for Bank Insolvency in India*

In India, the law relating to insolvency of banking companies is contained in the BR Act. The stated object of that Act is the protection of the interests of depositors. The Indian legal framework for bank insolvency relating to liquidation contemplates a special regime of insolvency initiated by the Reserve Bank (either on its own or as directed by the Central Government), but under the jurisdiction of the High Court. A special regime for bank insolvency has been provided for in the BR Act, 1949 wherein a separate chapter has been provided for the speedy disposal of winding-up proceedings against banks. The grounds on which the Reserve Bank may file a winding-up petition against a bank have also been provided in the legislation.

The BR Act provides for the passing of a moratorium order by the High Court on an application by the banking company which is temporarily unable to meet its obligations, staying the commencement or continuance of all actions and proceedings against the company up to a maximum period of six months. However, the Reserve Bank can, in such cases, make an application for winding-up of that banking company on the grounds that its affairs are being conducted in a manner detrimental to the interests of depositors. There are express provisions in the BR Act and the RBI Act granting protection to the Reserve Bank and its officers in respect of anything which is done or intended to be done in good faith under that Act.

As regards reconstruction of a banking company, the Indian legal framework (BR Act, 1949) has provided for a special regime administratively implemented by the Reserve Bank/Central Government by way of a scheme. The provisions of the BR Act provide for imposition of an order of moratorium in respect of a bank, before its reconstruction/compulsory amalgamation, by the Central Government on the application of the Reserve Bank.

The law provides for voluntary amalgamation at the instance of the banks and compulsory amalgamation at the instance of the Reserve Bank. Though voluntary amalgamations may be resorted to by banks for various considerations, one such consideration could be avoiding the risk of insolvency. The Reserve Bank has been empowered to sanction such voluntary amalgamations. In recent years, private sector banks have shown keen interest in taking over weak banks through the process of amalgamation on account of various business considerations.

The compulsory amalgamation of one bank with another bank is based on a scheme prepared by the Reserve Bank and sanctioned by the Central Government; amalgamation is preferred over reconstruction of the failed banking company. Compulsory amalgamation measures in the case of failed banks enable public confidence in the systems to be retained and avoid systemic risks. In view of the above position, winding-up proceedings are rarely resorted to by the Reserve Bank. The CFSA feels that this status must continue.

Compulsory amalgamation measures in the case of failed banks enable public confidence in the systems to be retained.

The flexibility of the extant regulations in permitting these mergers and amalgamations may get attenuated under the provisions of the Competition Act, which envisages that a combination is required to give notice to the Competition Commission before entering into a combination and wait for a maximum period of 210 days; the opinion of the regulator has not been given any binding effect and the final decision has been left to the Commission.[127]

Due to the complexity of the Indian banking sector, different legal principles apply to insolvencies of banks which are statutory corporations, nationalised banks and those in the co-operative sector. The law empowers the Central Government to make schemes for reconstitution/amalgamation/transfer of undertaking of a nationalised bank. In the case of the SBI and its subsidiary banks, the banks may be placed under liquidation only by orders of the Central Government and in the manner directed by it. As regards co-operative banks, the provisions of the BR Act, 1949 regarding winding-up/amalgamation is not applicable, except for imposition of a moratorium by the Central Government on the application of the Reserve Bank. The provisions of the respective Co-operative Societies Acts would be applicable for the purposes of liquidation and reconstruction/amalgamation of the co-operative banks. The Multi-State Co-operative Societies Act, 2002 deals with the winding-up of multi-state co-operative societies. The Central Registrar has been conferred with the power to direct winding-up of such co-operative societies.

*Assessment of Bank Insolvency Issues in India*

The Indian legal framework for insolvency of banking companies is in substantial compliance with emerging international standards. However, one major area in which there are no clear legal provisions in respect of bank insolvency is the formal legal mechanism for sharing of information with other regulatory bodies and overseas regulators and the extent of co-operation between them. Further, the priority of the claims of the DICGC over other creditors also needs to be unambiguously clarified by inserting an appropriate provision in the DICGC Act, 1961.

The failure of co-operative banks and the rescue measures in that sector continue to be areas of considerable concern, mainly on account of issues like the dual control of such co-operative banks by the Reserve Bank and the State Governments. Following are the main issues:

[127] This issue has been discussed in detail in Section 5.8 on Competition Issues.

- In the case of the failure of a co-operative bank, the Reserve Bank's powers extend only to the stage of imposition of a moratorium and, as regards amalgamation, the powers are vested in the State Governments.
- The Co-operative Societies Acts of the respective States permit amalgamation of a co-operative bank only with another co-operative bank and not with any other entity.
- The Co-operative Societies Acts prevailing in certain States are not in conformity with the provisions of the DICGC Act for availing the deposit insurance cover. In the case of regional rural banks (RRBs) also, amalgamation is permissible only with another regional rural bank.

In view of the above, a great deal needs to be done to instill public confidence in co-operative banks and ensure their stability. Similarly, effective measures need to be explored to make RRBs more efficient and stable and, wherever found unviable, to facilitate consolidation.

There are no solvency issues in the case of public sector banks (including the SBI and its subsidiaries) as the sovereign is the majority shareholder in these banks. The Central Government would take into account all factors including the interests of depositors, banking policy, and public interest even in the unlikely event of any order of winding-up being required to be passed.

Since 1993-94, public sector banks and RRBs in India are being recapitalised by the Government to meet the prescribed capital to risk-weighted assets ratio (CRAR) and the gap created by the application of prudential accounting norms. Over the years, the total capital contributed by the Government amounts to around Rs.22,000 crore or one per cent of GDP on cumulative basis up to 2002-03.[128] Based on cross-country evidence, this cost has been negligible.

In view of several legal complexities, the Panel noted that it would be worthwhile to have a separate, common and comprehensive insolvency code for banking institutions irrespective of the nature of entity involved, which is entirely different from the general insolvency code applicable to corporates, individuals, firms and societies. Further, while adopting the UNCITRAL Model Law on Cross-border Insolvency, suitable clarificatory provisions should be inserted in the statute to the effect that the special insolvency regimes for banks, NBFCs and insurance companies would be outside its purview. The peer reviewer has also stated that while adopting the UNCITRAL Model Law, issues like liquidating overseas branches of Indian banks and liquidation of a foreign bank with Indian presence need to be considered. The CFSA feels that these proposals could be considered for implementation.

A great deal needs to be done to instill public confidence in co-operative banks and ensure their stability.

[128] Source: RBI and Comptroller and Auditor General of India, 1999-2000 (for data up to 2000) supplemented by Union Government Finance Accounts (subsequent years).

### 5.8.4 Insolvency of Insurance Companies and NBFCs

The provisions of the Companies Act, 1956 relating to winding-up are applicable to insurance companies, subject to the relevant provisions of the Insurance Act, 1938. The Insurance Act, 1938 prohibits the voluntary winding-up of a company except for effecting amalgamation or when it cannot continue its business by reason of its liabilities. Where the insurance business or any part of the insurance business of an insurance company (secondary company) has been transferred to another insurance company (principal company) under an arrangement, if the principal company is being wound up, it shall also commence (subject to certain conditions) winding-up proceedings against the secondary company, unless otherwise ordered by the Court. The Insurance Act, 1938 enables part of the business of an insurance company to carry on, while the remaining part is wound up. However, composite insurance companies are not permitted by the IRDA.

The provisions of the Companies Act, 1956 are applicable to the winding-up of NBFCs and, under the RBI Act, the Reserve Bank is also empowered to file petitions for winding-up of NBFCs.

### 5.8.5 Major Observations and Recommendations

Effective creditor rights and insolvency systems play a vital role in helping to sustain financial soundness and promote commercial confidence by enabling market participants and stakeholders to more accurately price, manage and resolve the risks of default and non-performance. Uncertainty about the enforceability of contractual rights increases the cost of credit to compensate for the increased risk of non-performance and could lead to credit tightening. Attracting loans and investment requires that repayment risks are reasonable and manageable. Collateral without reliable enforcement affords little genuine protection. An efficient system for enforcing debt claims is crucial to the functioning of the financial system.

An efficient system for enforcing debt claims is crucial to the functioning of the financial system.

The insolvency law framework for banks, NBFCs and insurance companies and the general corporate insolvency regime are broadly compliant with World Bank Principles. However, there are several gaps, particularly in the implementation of the extant legislation.

A robust insolvency regime that provides assurance to investors that the winding-up process will be completed within a reasonable time-frame and with minimal loss to stakeholders is a prerequisite for a country like India that is seeking to enhance long-term investment opportunities both domestically and from abroad to sustain its high growth trajectory. In this regard, more

than the nominal compliance with international principles, the importance of effective compliance, in terms of implementation, gain significance.

The average time taken for bankruptcy proceedings in India is 10 years.

The assessment of the Advisory Panel has brought out in detail the complexities of legal and judicial systems in India, raising concerns about the long delays in the winding-up process. Whereas a legal amendment to the Companies Act, based on the recommendations of an expert Committee, has been made, enabling the setting up of a NCLT, this major proposal itself could not take off due to a pending law suit. The peer reviewer has noted that the Supreme Court's determination of the appeal pending against the amendment to the Companies Act will have a significant impact on the implementation of bankruptcy laws in India.

While the CFSA notes that the constitution of the NCLT would bring about a change that would significantly improve the convergence of the Indian situation to international principles, it urges that the other recommendations to address the gaps in observance should invite serious and urgent attention. Enactment of appropriate laws to ensure faster insolvency resolution is necessary for the development of corporate debt market and, particularly, the securitisation markets.

*Inordinate Delays in the Winding-up Process*

At present, the mechanism of rehabilitation through the SICA has been a failure. The winding-up petitions and cases referred to BIFR take a very long time for final disposal. A cross-country comparison on closing a business in the World Bank's 'Doing Business Report' (2008) has analysed the main indicators to identify weaknesses in the existing bankruptcy laws and the main procedural and administrative bottlenecks in the bankruptcy process (Table 5.9). These indicators include (i) average time to complete a procedure, (ii) cost of the bankruptcy proceedings and (iii) the recovery rate, which calculates how many cents on the dollar the claimants (creditors, tax authorities, and employees) recover from an insolvent firm. The average time taken for bankruptcy proceedings in India is 10 years. The cost of bankruptcy proceedings in India is stated to be 9 per cent of the estate and the recovery rate (for claimants) is found to be 11.6 cents on the dollar (or 11.6 per cent of assets).

A study of Table 5.9 further shows that the recovery rate at 11.6 per cent is the lowest among all the countries listed and the average time for completing the winding-up process is the highest at 10 years. The time taken is so high that no other country or region is even close to the India's deplorable situation. Indonesia, with 12.6 per cent recovery, is close to India in terms of recovery rate, but the duration even in that case is only 5.5 years.

The recovery rate at 11.6 per cent is the lowest among all the countries listed.

The correlation based on the cross-country table relating to the duration and recovery rate works out to be a significant negative at -0.7131

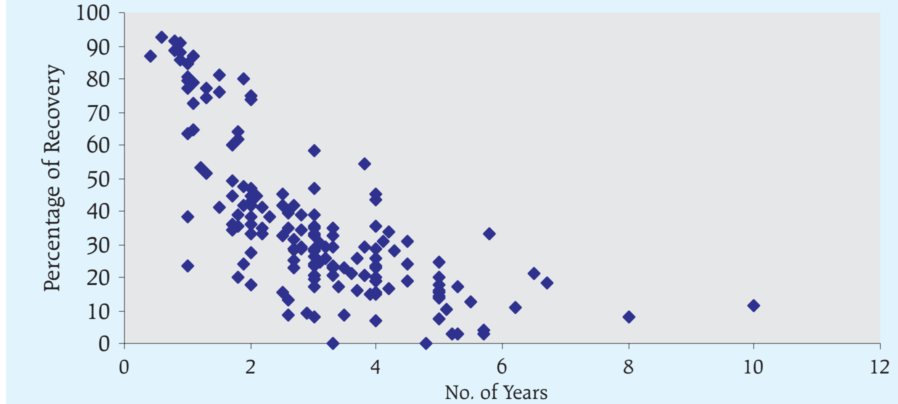
**Table 5.9: Cross-country Comparison on Closing a Business**

| Region or Economy | Time (years) | Cost (% of estate) | Recovery rate (cents on the dollar) |
|---|---|---|---|
| East Asia & Pacific | 2.7 | 23.2 | 28.1 |
| Eastern Europe & Central Asia | 3.2 | 13.7 | 28.9 |
| Latin America & Caribbean | 3.2 | 16.4 | 25.9 |
| Middle East & North Africa | 3.7 | 13.9 | 25.8 |
| OECD | 1.3 | 7.5 | 74.1 |
| South Asia | 5.0 | 6.5 | 20.1 |
| Sub-Saharan Africa | 3.4 | 20.0 | 17.1 |
| Argentina | 2.8 | 12 | 34.4 |
| Australia | 1.0 | 8 | 79.2 |
| Bangladesh | 4.0 | 8 | 23.2 |
| Chile | 4.5 | 15 | 23.8 |
| China | 1.7 | 22 | 35.9 |
| France | 1.9 | 9 | 47.4 |
| Germany | 1.2 | 8 | 53.4 |
| Hong Kong, China | 1.1 | 9 | 79.0 |
| India | 10.0 | 9 | 11.6 |
| Indonesia | 5.5 | 18 | 12.6 |
| Japan | 0.6 | 4 | 92.6 |
| Korea | 1.5 | 4 | 81.2 |
| Mexico | 1.8 | 18 | 63.9 |
| Pakistan | 2.8 | 4 | 39.1 |
| Russia | 3.8 | 9 | 29.0 |
| Sri Lanka | 1.7 | 5 | 44.6 |
| Chinese Taipei | 1.9 | 4 | 80.2 |
| Thailand | 2.7 | 36 | 41.8 |
| United Kingdom | 1.0 | 6 | 84.6 |
| United States | 1.5 | 7 | 75.9 |

Source: The World Bank http://www.doingbusiness.org/

(Chart 5.5). This clearly establishes that the time taken for the winding-up process is a significant factor that influences the recovered proportion of assets under consideration. The CFSA, therefore, places top priority for the authorities to improve and rationalise the systems and procedures to minimise the huge loss inflicted on stakeholders on account of the insolvency process in India. The need to have an efficient bankruptcy law for the financial sector is essential from the point of view of the efficiency of the systems as well as the stability of the financial sector. As stated above, long delays in settling the liquidation proceeds leads to a poor recovery rate of assets, causing losses for the banking sector which have implications for financial stability. Banks also need to provide for these loss assets, thus, reducing the funds available with them for lending to productive sectors of the economy.

## Chart 5.5: Recovery Ratio and Time of Resolution of Insolvency




A survey by the Technical Group to ascertain the status of laws at the implementation stage attempted an empirical analysis with the available data relating to the recovery/insolvency regime in India. The survey results broadly confirm the results of the World Bank data.

In order to ascertain the reasons for delay in resolution of cases filed in DRTs and civil cases pending in High Courts, the Technical Group collected data from four major banks. Of the four, only one bank could furnish data along with the time taken for resolution of the cases. Another bank has given qualitative data on the delay in settlement of bankruptcy cases, while the remaining two banks have informally expressed their inability to provide data as they are do not compile such data. The granular data provided by one bank was analysed, even though the data analysis suffers from small sample error. The mean and standard deviation in respect of the cases pending in DRTs are 8.2 years and 4.5 years, respectively. As per the information received from another bank, the DRTs take a period of 2 to 4 years to pass an order and, after that, six months to one year is taken to obtain a Recovery Certificate. The mean and standard deviation in respect of settlement of civil suits pending in Courts (based on the data set furnished by one bank) are 4 years and 5 years, respectively. As per the information received from one bank, it takes, on an average, 2 to 3 years to obtain a decree, and the execution of the decree takes another 3 to 4 years. Based on the information on the pending BIFR cases, the mean and the standard deviation in respect of cases pending in the BIFR are 8.25 years and 4.96 years, respectively, (for BIFR cases pending for more than 10 years, the average pendency has been assumed as 15 years to calculate the mean and standard deviation). The mean and standard deviation in respect of settlement of winding-up cases (based on the data set furnished by one bank) are 11.25 years and 7.1 years, respectively. As per the qualitative data furnished by one bank, winding-up cases take an average of 5-10 years for resolution. The data on companies under liquidation obtained from the Office of Official Liquidator indicate that the average time taken for concluding liquidation proceedings is about 10 years.

The mean and the standard deviation in respect of cases pending in the BIFR are 8.25 years and 4.96 years, respectively.

The data in respect of winding-up petitions filed by the Reserve Bank against NBFCs under Section 45 MC of the RBI Act, 1934 indicate that such petitions have been pending for a period ranging between 5 to 10 years. The time taken for final resolution of the disputes depends on several factors, such as number of lenders involved in the dispute, the level of support provided by each of the lenders, and the borrowers' ability to bear the additional cost of rehabilitation/restructuring. In respect of Central PSU/State PSU units, the stand taken by the Government of India/State Governments and labour unions is also important in deciding the time taken for resolution. The stands of labour unions are important in private sector companies also. In liquidation proceedings, the legal machinery involved have their own handicaps. These handicaps include absence of specialised tribunals to exclusively deal with liquidation/rehabilitation, absence of provisions for appointing liquidators other than Official Liquidators, lack of infrastructure at the Office of the Official Liquidator, delays in determining the claims of workmen and disputes relating to such claims.

### 5.8.6 Companies Bill, 2008

The Central Government has recently introduced the Companies Bill, 2008 which seeks to replace the Companies Act, 1956. The bill has been introduced with the objective of enabling the corporate sector in India to operate in a regulatory environment of international best practices that foster entrepreneurship, investment and growth. The Bill seeks to provide, *inter alia*, for (i) detailed declarations/disclosures about the promoters/directors, at the time of incorporation itself, (ii) a revised framework for regulation of insolvency including rehabilitation, winding-up and liquidation of companies, with the process to be completed in a time-bound manner, (iii) a comprehensive chapter for rehabilitation of sick companies (including by way of amalgamation with other companies), (iv) registration of valuers for the purpose of undertaking valuations as required in the proposed Act, (v) establishment of special courts for speedy trial of offenders under the proposed Act, and (vi) class action proceedings by creditors in cases where the management of the affairs of the company are conducted in a manner prejudicial to the interests of the company or creditors.

### 5.8.7 Other Aspects

The Advisory Panel has made other recommendations to bring the Indian system to international standards from the angle of strengthening the

insolvency regime, taking into account stakeholders' interests and the needs of a robust credit system to cater satisfactorily to a large section of the Indian populace. The assessment addresses several weaknesses in the current regime.

Certain provisions in the law which give priority to the sovereign claims of secured creditors cause concern to the secured creditors as regards their security interest. The lack of a registry which keeps a record of the security interests created in respect of movable properties is another lacuna in the system of registration of security interests. The orders issued by certain State Governments on restricting sale and mortgage of land belonging to specified categories, like agriculturists, is a disincentive to creditors for giving loans on the security of such land. Even though the legal principles governing enforcement mechanism are adequate, there are delays in implementing these principles at the ground level. The recovery mechanism in the case of unsecured credit is less efficient and cases are pending for execution with the DRTs due to lack of information about the properties of the debtors. Though there are provisions in respect of calling for claims and their adjudication in liquidation proceedings, in case of any dispute the matter is placed before the court for its decision. This takes a long time to be resolved and the claims of other creditors are also held up due to such disputes. The lack of judicial time, expertise and consequent lack of proper appreciation of issues pertaining to insolvency cause delays in deciding court cases.

The lack of judicial time, expertise and consequent lack of proper appreciation of issues cause delays.

In the above regard, the CFSA feels that the views and recommendations of the Panel as listed below should be considered for implementation.

*Legal Framework for Creditor Rights*

The contractual rights of creditors are recognised under the laws in India. Certain provisions of law which give priority to sovereign claims over the claims of secured creditors have been causing concern to the secured creditors as regards their security interests. The law should provide that the priority of charge for the State should not operate in respect of prior mortgages created in favour of secured creditors. Since there are no comprehensive credit guarantee schemes in the market, it would be worthwhile to improve the scheme notified under the DICGC Act, 1961.

*Security (Immovable Property/Movable Property)*

Even though the general laws permit creation of security interests over immovable properties, certain revenue orders issued by State Governments have acted as disincentives for creditors to extend loans. States should take steps to remove the restrictions on creation of security interests in favour of banks and financial institutions, in respect of lands belonging to specified categories, by rescinding the revenue orders or by way of legislations as the case may be.

Stamp duties charged by the States should be nominal so that they do not hamper the transfer of immovable properties and interests therein.

The law should provide that the priority of charge for the State should not operate in respect of prior mortgages created in favour of secured creditors.

It is worthwhile to have a common legislation dealing with creation and registration of security interests (collaterals) irrespective of the nature of the security and its location. Eventually, the Central Registry should be the sole registry of all security interests.

*Recommendations concerning the SARFAESI Act*

There is a need to amend Section 14 of the SARFAESI Act to provide an enabling provision for the district magistrate to delegate his powers under the SARFAESI Act to other executive magistrates in the District, so that the delay in taking possession/control of the secured asset may be obviated.

The SARFAESI Act should be extended to cover security interests in agricultural land beyond a specified holding, say five acres, which would be exempt from the provisions of the SARFAESI Act.

The Central Registry under the SARFAESI Act, which can take care of a major part of the transactions of banks and financial institutions, is yet to be set up. The Central Registry should be set up urgently to have a central and reliable record of all security interests created by banks and financial institutions. The system of registration of security interest in respect of immovable property, motor vehicles, intellectual property and in respect of assets of companies provides adequate notice of creation of the security interest to the general public. However, there is no registry which keeps a record of the security interests created in respect of other movable properties.

The Central Registry should also be allowed to register all transactions creating security interests (both in movable as well as immovable property) by entities/individuals in addition to those of banks/financial institutions. For this purpose, it is appropriate to bring in separate legislation in respect of the Central Registry. In course of time, the Central Registry (with an adequate number of branches all over the country) should be the sole registry for registration of all security interests over properties, and the registries under various statutes should be wound up with suitable amendments to the respective Acts dealing with registration of security interests. The Central Registry should be constituted to provide a good database and reliable record on the creation of security interests/charges under the SARFAESI Act, This would also be an authentic source of public notice. It should also be allowed to register all transactions creating security interest (both in movable as well as immovable property) by entities/individuals other than banks/financial institutions.

The SARFAESI Act should be extended to cover security interests in agricultural land.

DRTs granting *ex parte* stay orders against sale of securities by banks/ financial institutions under Section 13(4) of the SARFAESI Act is a matter of serious concern. A suitable provision to safeguard the interests of lenders needs to be inserted in the SARFAESI Act.

*Registry Systems*

There is a need to computerise the records of the Registrar of Assurances to link them to the Central Registrar and provide an online search facility. Measures should be taken by all State Governments in this regard. The online search facility has to be provided to verify the existence of a security interest over a patent, trade mark or design after making payments online.

There should be an express provision for the registration of charges over trade marks under the Trade Marks Act, 1999.

*Jurisdiction of Recovery Tribunals*

Even though the number of new cases filed in the DRTs has come down owing to the enactment of the SARFAESI Act, the number of pending cases is still large. In order to minimise the delay, the number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rs.1 crore and above.

*Risk Management and Corporate Workout*

There is a need to grant priority, by statute, to claims by banks or financial institutions in respect of the financial assistance given to rehabilitate companies in financial distress. Such priority of claim should also be extended while disbursing the assets in liquidation. However, NCLT should be made functional for any significant improvement in the restructuring process.

*Legal Framework for Insolvency*

To achieve a more transparent, predictable and sound insolvency system, there is a need to consolidate all separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in such insolvency. The CFSA, however, notes that the Panel on Financial Stability Assessment and Stress Testing has recommended a separate code for banks.

It is advisable to keep insolvency procedures of entities with systemic risk, like banks/insurance companies, separate from insolvency relating to ordinary companies, and the law should provide a time-frame to conclude liquidation proceedings.

While disbursing the assets in liquidation, there is a need to provide for priority to the financial assistance given at the time of rehabilitation to entities that have suffered losses as a result of matters beyond their control, by inserting a special provision in the Companies Act.

There is a need to grant priority, by statute, to claims by banks or financial institutions in respect of the financial assistance given to rehabilitate companies in financial distress.

There is a need to consolidate all separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum.

There is no provision in law enabling cross-border insolvency proceedings.

There is no provision in law enabling cross-border insolvency proceedings. The UNCITRAL Model Law on Cross-border Insolvency, with suitable clarificatory provisions, should be inserted in the statute to the effect that the special insolvency regimes for banks, NBFCs and insurance companies would be outside its purview.

The SICA is used to deal with the rehabilitation of sick industrial undertakings. In terms of the Act, the board of directors of a sick industrial undertaking could refer to the BIFR, set up under the provisions of the Act to determine measures to be taken against that undertaking. BIFR would then conduct an enquiry into the working of the company. Winding-up petitions and cases referred to BIFR take very long for final disposal. Companies often use the SICA to prevent creditors from proceeding against them; this is on account of the statutory stay on initiation/continuance of suits or other legal proceeding once a reference is made to the BIFR. The mechanism of rehabilitation through SICA is not effective. The new provisions introduced in the Companies Act vide the Companies (Second Amendment) Act, 2002 once brought into operation, are expected to improve the rehabilitation mechanism. A separate bench of NCLT should be set up to deal with cases involving rehabilitation involving loan amounts of Rs.10 crore and above.

*Provisional Measures and Effects of Commencement* [129]

The Companies (Second Amendment) Act, 2002 should be brought into operation since it seeks to expressly empower the Court/Liquidator to take relevant measures to protect the properties of the company during the proceedings. The law provides for a general stay on suits and proceedings against the assets of the company. However, such a stay is not applicable to a secured creditor who enforces his security interest outside the winding-up proceedings. Unless and until the Court passes an order in an insolvency petition, the company is free to deal with its properties. This may erode realisation, unless a Provisional Liquidator is appointed to manage the affairs. The law should provide for an automatic stay on the creation of further liabilities on or alienation of the company's assets, camouflaged as in the ordinary course of business, after the presentation of a winding-up petition and service of its notice on the company. As a safeguard against the abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and malafide petitions.

The law should provide for an automatic stay on the creation of further liabilities on or alienation of the company's assets, after the presentation of a winding-up petition.

[129] Commencement refers to the commencement of insolvency proceedings after all efforts to revive and rehabilitate a firm have failed.

Because of delays, the actual realisation of assets in liquidation is very low and there is a need to provide an expeditious disposal mechanism for better valuation.

*Creditors and the Creditors' Committee*

The law should provide for a creditors' committee at the initial stage of insolvency proceedings to consider the reorganisation of the company. There should be provision for an exclusive creditors' committee/assembly in insolvency laws, when the liquidator is not a creditor-nominated liquidator. Such committees should be empowered to participate in the decisions along with the liquidator, and to file reports independently to the court/tribunal for improving liquidation proceedings. The law should provide for nominating unsecured creditors in the creditors' committee to ensure their participation and to safeguard their interests.

*Administration*

The Companies (Second Amendment) Act, 2002 should be brought into operation quickly to empower the Liquidator/Court to protect the assets of the company and to even sell the undertaking as a going concern.

*Treatment of Contractual Obligations*

There should be express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during reorganisation and winding-up. A limited extent of certainty has been introduced by way of the Payment and Settlement Systems Act, 2007 in respect of contracts in a payment system. However, the position is not yet clear regarding the treatment of Over-the-Counter transactions in derivatives settled outside 'payment systems' regulated under the Payment and Settlement Systems Act, 2007 especially the closing-out provisions in such contracts.

*Claims Resolution Procedures*

The implementation of the provisions relating to the receipt of claims and their process in liquidation needs to be improved to reduce delay.

*Reorganisation Proceedings*

The law should provide for setting time-limits for the approval of a re-organisation plan. It would be necessary for the legal provisions to limit the number of plans that can be submitted for sanction before the court or provide for the automatic lapse of a scheme if the same is not approved within a specified period, say within three months or six months, from the date of submission.

The law should provide for setting time-limits for the approval of a re-organisation plan.

In rehabilitation proceedings under SICA, there should be a provision for appointment of a creditor-nominated representative/committee.

There is a necessity for incorporating provisions that would compel companies to periodically report the implementation of their plan to the

Regional Director/Department of Company Affairs till all the terms and conditions of the plan are substantially complied with and the court passes final orders to that effect.

*Judicial Decision-making and Enforcement of Orders*

Certified copies of court orders should be made available online to improve the efficiency and utility of the system.

The lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency causes delays in deciding court cases. This can to a large extent be solved if the NCLT and the NCLAT are set up.

**5.8.8 Summary**

A robust and efficient legal framework is essential for the stability and smooth functioning of the financial sector. The amendments to various legislations relevant to the financial sector have given greater legislative mandates to the regulators in discharging their regulatory and supervisory roles. However, the CFSA feels that there is a need to harmonise the legislative framework in India, particularly with regard to legislations in the financial sector. Moreover, the recently amended provisions of the Competition Act, 2002 raise concerns with regard to regulatory overlap/conflict of interest in the financial sector. The CSFA feels that the Government should review the powers of the Competition Commission regarding mergers and amalgamation of banks/other financial institutions, which has far-reaching implications for the stability of the financial sector.

The assessment of adherence to the World Bank Principles for Effective Insolvency and Creditor Rights Systems has brought out the fact that despite having well-conceived insolvency laws and institutional framework, the implementation of these laws leaves a lot to be desired. The 'Doing Business Report' of the World Bank has highlighted India's low ranking in enforcing bankruptcy laws due to the lengthy process in completing the liquidation proceedings and the extremely low recovery rate.

The CSFA feels that the Government should review the powers of the Competition Commission regarding mergers and amalgamation of banks/other financial institutions.

Some of the major issues and related recommendations of the CFSA are as follows:

The insolvency of financial institutions will have a serious contagion effect and repercussions across the economic system, thereby destabilising economic activity. Accordingly, a separate comprehensive insolvency regime for banks and other categories of financial institutions is vital in the context of financial stability.

A legal amendment to the Companies Act, enabling the setting up of a National Company Law Tribunal (NCLT), has been held up due to a pending law suit. The constitution of NCLT would bring about a significant change in improving India's insolvency framework. Enactment of appropriate laws to ensure faster insolvency resolution is necessary for the development of corporate debt and, particularly, the securitisation markets.

Certain provisions of law which give priority to sovereign claims over the claims of secured creditors are detrimental to secured creditors as regards their security interests. The law should provide that the priority of charge for state dues should not operate in respect of prior mortgages created in favour of the secured creditors.

States should take steps to remove the restrictions on creation of security interests, in favour of banks and financial institutions in respect of lands belonging to specified categories like agriculture, by way of rescinding the revenue orders or by way of legislations as the case may be.

There is no registry which keeps a record of the security interests created in respect of movable properties. A Central Registry under the SARFAESI Act, which can take care of a major part of the transactions of banks and financial institutions, should be set up urgently to have a central and reliable record of all security interests created by banks and financial institutions.

The number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rs.1 crore and above as the number of pending cases with DRTs continues to be high despite a reduction in the filing of new cases.

The CFSA feels that, while adopting the Model Law on Cross-border Insolvency, suitable clarificatory provisions should be inserted in the statute to the effect that the special insolvency regimes for banks, NBFCs and insurance companies would be outside its purview.

## 5.9 Corporate Governance

### 5.9.1 Benchmark

The assessment of corporate governance has been done based on the OECD principles of corporate governance which were revised in 2004 (Box 5.10). It covers six main areas, *viz.*, effective institutional and legal framework to support good corporate governance practices; a framework that protects and facilitates the exercise of shareholders' rights; equal treatment of all shareholders (including minority and foreign shareholders); the role of stakeholders in corporate governance; timely, accurate and transparent disclosure mechanisms and responsibilities of the board and required procedures. Assessment with respect to each principle has been done on the scale of 'Fully Implemented', 'Broadly Implemented', 'Partially Implemented' and 'Not Implemented'.

A Central Registry under the SARFAESI Act should be set up urgently.

**Box 5.10: OECD Principles on Corporate Governance**

The OECD principles on corporate governance are intended to underpin an assessment of the implementation of the Principles in a jurisdiction and to provide a framework for policy discussions. The ultimate purpose of an assessment is to identify the nature and extent of specific strengths and weaknesses in corporate governance, and thereby underpin policy dialogue that will identify reform priorities leading to the improvement of corporate governance and economic performance.

The first set of principles (Principle I) deals with the fact that the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

The second set of principles (Principle II) deals with the fact that the corporate governance framework should protect and facilitate the exercise of shareholders' rights. Basic rights include the right to influence the corporation, the right to information, the right to sell or transfer shares and the right to participate in the profits or earnings of the corporation. Shareholders' rights to influence the corporation centre on certain fundamental issues, such as the election of board members, or other means of influencing the composition of the board, amendments to the company's organic documents and other basic issues.

The third set of principles (Principle III) deals with the fact that the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. The ultimate aim is to preserve the integrity of capital markets by protecting non-controlling shareholders from potential abuse such as misappropriation by boards, managers and controlling shareholders.

The fourth set of principles (Principle IV) deals with the fact that the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The concept of stakeholder refers to resource providers to the corporation including employees, creditors and suppliers.

The fifth set of principles (Principle V) deals with the fact that the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. It deals with the type of material information which should be disclosed, how and to whom this information should be communicated and the processes by which confidence in the quality of the information can be ensured.

The sixth set of principles (Principle VI) deals with the fact that the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. The companies are professionally managed but subject to effective oversight by the board so as to prevent self-dealing and to ensure that the interests of shareholders are taken into account by the management.

### 5.9.2 Earlier Assessments

The Advisory Group on Corporate Governance (2001) assessed India's corporate governance standards in listed companies; it also assessed governance practices in banks and public sector companies. The Group recommended that with regard to companies, the board of directors needs to look into improving the quality of information which they provide to shareholders, and they should furnish consolidated accounts incorporating the performance of subsidiaries; audit committees should have a say in the selection of auditors and the board should take measures to enhance the independence and stature of auditors.

As regards banks, the Group recommended that bank boards should play an active role in providing oversight of the way in which senior management approaches different kinds of risks which banks face, such as credit, market, liquidity and operational risk. The regulations regarding limits on individual shareholdings and voting rights should be made uniform, irrespective of whether the banks are in the private or public sector, and there should be much stronger internal control systems, including effective internal and external audit mechanisms, risk management functions independent of business lines, and other checks and balances.

As regards public sector companies, the key recommendations included: the information provided to the shareholders should give a comparative picture with reference to other companies in the same/similar industry as also with reference to the industry as a whole; it should give consolidated accounts incorporating performance of subsidiaries; all listed Government companies should give information regarding the controlling stake of major shareholders in various government companies; and the board of directors needs to look into improving the quality of information which they provide to shareholders.

By way of improving governance in respect of the three categories, the Group further recommended that the audit committees should be formed as per the recommendations of the Blue Ribbon Committee in all companies, including banks and public sector enterprises. The audit committee should solely comprise independent directors; the boards of large companies and banks should meet at least six times a year; and banks and companies should be required to prepare and present consolidated financial statements including those of all its subsidiaries.

The Report on Observance of Standards and Codes, (April 2004) by the World Bank had also carried out an assessment of corporate governance in India. It had recommended that sanctions and enforcement should be credible deterrents, especially in the area of insider trading and related party transactions. Further, it had observed that there is a fragmented structure of regulatory oversight over the listed companies, which leads to weaker enforcement and regulatory arbitrage. There is a need to strengthen board practices. There is a need to look into the role of institutional investors in the corporate governance of their portfolio companies.

There is a need to look into the role of institutional investors in the corporate governance of their portfolio companies – ROSC-2004.

### 5.9.3 Assessment and Recommendations by the Advisory Panel on Institutions and Market Structure

The present assessment was based on a study of the working of various constituents, namely, the corporate sector (listed and unlisted companies), banking, insurance and public sector enterprises. A summary of the assessment is furnished below:

Overall, the assessment shows that of the 32 OECD principles, 18 principles are 'Fully Implemented', 12 are 'Broadly Implemented' and two are 'Partially Implemented'. All the principles were thus complied with, *albeit* with some gaps to be plugged in the case of the 'Broadly Implemented' or 'Partially Implemented' Principles (Table 5.10).

The Panel noted that there is a comprehensive corporate governance framework in India for listed companies and the listing agreement forms an important pillar of the corporate governance framework. However, it also noted that there is a need to strengthen the corporate governance framework for unlisted companies. There are various legal and regulatory requirements in place pertaining to corporate governance. The roles and responsibilities of the various regulators are clearly defined and there are co-ordination mechanisms in place for interaction among various regulators. The supervisory, regulatory and enforcement authorities have authority, integrity and resources to fulfill their duties in a professional manner.

A number of initiatives have been taken to improve the rights of shareholders. There are enabling provisions in place which allow shareholders to participate in and be informed of decisions concerning fundamental corporate changes. Though there are enabling provisions in place which permit shareholders to participate in general meetings, alternate methods for voting need to be explored coupled with spreading awareness through investor education. The Panel observed that ownership through cross-holdings and use of trusts and private companies for owning shares in group companies gives rise to an opaque structure which needs to be addressed. The Report was peer reviewed by Sir Andrew Large, former Deputy Governor, Bank of England, who had commented upon listed vs. unlisted companies, insider dealing and market abuse, importance of stakeholders, disclosures in areas of accounting, auditing and risks and adoption of country-specific codes of good corporate governance. The comments of the peer reviewer have been appropriately incorporated in the Report of the Panel.

There is a need to strengthen the corporate governance framework for unlisted companies.

Based on the assessment, wherever the adherence is broadly or partially implemented, the Advisory Panel made some recommendations.

**Table 5.10: Summary Assessment of OECD Principles**

| Principle | Description | Assessment |
|---|---|---|
| **I.** | **Ensuring the basis for an effective Corporate Governance framework** | |
| IA | Enhancement of market integrity and promotion of transparent and efficient markets | BI |
| IB | Transparent and enforceable legal and regulatory requirements | FI |
| IC | Division of responsibilities amongst authorities | FI |
| ID | Efficient supervisory, regulatory and enforcement framework | FI |
| **II.** | **The rights of shareholders** | |
| IIA | Basic shareholder rights | FI |
| IIB | Rights to participate in fundamental decisions | FI |
| IIC | Shareholders' AGM rights | FI |
| IID | Disproportionate control disclosure | BI |
| IIE | Markets for corporate control should be allowed to function | BI |
| IIF | Cost/benefit to voting | PI |
| IIG | Consultation amongst shareholders, including institutional investors | FI |
| **III.** | **Equitable treatment of shareholders** | |
| IIIA | All shareholders should be treated equally | BI |
| IIIB | Insider trading and abusive self-dealing is prohibited | FI |
| IIIC | Board/Managers disclose interests | FI |
| **IV.** | **Role of stakeholders in corporate governance** | |
| IVA | Stakeholder rights respected | FI |
| IVB | Redress for violation of rights | BI |
| IVC | Performance enhancement | FI |
| IVD | Access to information | FI |
| IVE | Free communication of unethical practices to the Board | PI |
| IVF | Enforcement of creditor rights | BI |
| **V.** | **Disclosure and transparency** | |
| VA | Disclosure standards | FI |
| VB | Standards of accounting & audit | FI |
| VC | Independent audit annually | BI |
| VD | Accountability of auditors | BI |
| VE | Fair & timely dissemination | FI |
| VF | Provision of professional advice | BI |
| **VI.** | **Responsibilities of the Board** | |
| VIA | Board acts with due diligence, care | FI |
| VIB | Treat all shareholders fairly | BI |
| VIC | Apply high ethical standards | FI |
| VID | The Board should fulfill certain key functions | BI |
| VIE | The Board should be able to exercise objective judgment | BI |
| VIF | Access to information | FI |

FI – Fully Implemented; BI – Broadly Implemented; PI – Partly Implemented; NI – Not Implemented.

The CFSA notes that there are a few gaps in areas relating to corporate governance framework for listed companies, investor education, institutional investors, independent directors and penal provisions.

*Good Corporate Governance Practices*

The Panel noted that Indian corporates have begun to play a major role globally, especially in service sector areas like information technology, BPO and finance where India has an edge over other countries. India is increasingly emerging as a manufacturing base for international corporations and Indian companies have made significant acquisitions of entities abroad. The practices followed by the Indian corporates would come under the scrutiny of potential stakeholders at the global level. Hence, the Panel felt that the quality of corporate governance in these companies would be a key determinant affecting their ability to attract capital, business, global partners and quality manpower. It felt that this would go a long way inasmuch as good corporate governance in such companies is likely to be emulated by other corporates, thereby enhancing overall levels of corporate governance in India.

*Listed Companies*

The Panel noted that certain requirements of Clause 49 of the listing agreement are non-mandatory. Generally, the feeling was that many companies would move over time towards complying with the non-mandatory requirements. Given that listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted, the Panel recommended that the listed companies be required to also disclose the reasons for non-compliance with non-mandatory requirements.

The Panel noted that in terms of Clause 49 of the listing agreement, the requirement to establish the whistle-blower mechanism is not mandatory and depends on the discretion of the companies. Accordingly, the Panel felt that it may be worthwhile to gather information on the experience of the companies which chose to implement this mechanism so far, and consider a further course of policy change, if any, in this area.

The Panel noted that recent developments in the derivatives market have brought to the forefront the importance of risk management. The peer reviewer, Sir Andrew Large, felt that the importance of thinking about risk and the disclosure aspects in this regard have never been more important. Hence, the Panel felt that there is a need to strengthen the existing framework with regard to risk management in the listed companies. Introducing the requirement of having Risk Committees can be specifically explored in this regard.

While international practices and developments have apparently been factored into the evolution of the corporate governance framework in India,

the Panel felt that it is essential that learning from the experience of other countries should be a dynamic process and not a static one. Hence, the corporate governance code should be constantly reviewed in light of the ever-changing global scenario.

*Issues Relating to Investors*

The Panel noted that investor education can play a key role in spreading awareness about exercise of their rights and impact on board governance. Work in this direction is already being done by the various concerned authorities, which needs to be taken up on a larger scale and reach. A co-ordinated approach amongst authorities can further enhance effectiveness of efforts in this direction. It also notes that there are certain constraints which prevent a shareholder from participating in AGMs/EGMs due to their dispersed geographical spread. A number of initiatives have been taken in this regard, such as introduction of postal ballots for voting for some decisions and provision for proxy voting. However, to increase participation by shareholders, the Panel recommended that some more initiatives can be taken: *e.g.*, the AGM could be held where majority shareholders reside; alternate methods of voting which are convenient to shareholders could be explored; and investor associations can play an active role in providing a platform for co-ordination among investors.

The Panel felt that institutional investors need to be encouraged to declare their voting policy and to effectively participate in corporate decision-making as they are expected to have better knowledge and understanding of the affairs of the company. There is a need to initiate dialogue with the industry to develop awareness about the contribution that institutional investors can make in the corporate governance of a portfolio company. Hence, the Panel recommended that the possibility of stipulating specific requirements either as good practice or mandatory requirements needs to be explored.

*Independent Directors*

The Panel noted that though in the present scheme of things substantial importance is given to independent directors, as regards listed companies there is no mandatory requirement pertaining to their tenure. It recommended that there is a need to prescribe an upper limit on the tenure of independent directors in the law and, in due course, this could be incorporated through an amendment to the Companies Act.

The Panel noted that credible institutional mechanism for the training of directors including the independent directors needs to be created on a priority basis. It also noted that steps have already been initiated in this regard by Ministry of Corporate Affairs as well as SEBI, ICAI and ICSI which are playing a crucial role in addressing this requirement.

Learning from the experience of other countries should be a dynamic process.

*Penal Provisions*

The Panel noted that ownership through cross-holdings and use of trusts and private companies for owning shares in group companies gives rise

Strengthen the disclosure mechanism to bring about greater transparency in ownership structures.

to opaque structures. Hence, it felt that there is a need to strengthen the disclosure mechanism to bring about greater transparency in ownership structures. It adds that stringent penal action needs to be taken whenever such undesirable practices are unearthed.

The Panel felt that there is a need to strengthen the enforcement mechanism by focusing efforts on tracking defaulters or non-compliance by the company, which would act as deterrents for future non-compliance and also boost the confidence of investors in the system.

The Panel noted that various provisions have been incorporated, both under the Companies Act and the Listing Agreement, to address the conflict of interest issue in related party transactions. As a further step, the Panel recommended that appropriate penalties may be provided for in the law for non-compliance pertaining to related party transactions. The Panel also recommended that penal provisions for fraudsters may be strengthened in corporate law by providing for the disgorgement of gains and confiscation of assets.

*Institutional Mechanism for Resolution of Cases*

The Panel observed that though India today has a robust regulatory framework, there are bottlenecks due to delays in the judicial process. The liquidation process is time-consuming and lengthy, thereby leaving hardly any effective remedy for stakeholders other than secured creditors. It has been observed that setting up dedicated courts for certain areas has led to the expeditious disposal of cases. Therefore, the Panel recommended that an effective institutional mechanism for time-bound resolution of cases needs to be created urgently.

*Other Issues*

An effective institutional mechanism for time-bound resolution of cases needs to be created urgently.

The peer reviewer, Sir Andrew Large, noted that the unlisted sector is a significant part of the corporate world in India. In addition, a number of Indian groups have deliberately moved into the unlisted sector, attracted by less onerous requirements and presumably not deterred by potentially lower access to capital. He felt that, over time, higher standards in the unlisted sector will be good for the cost of capital. Certainly, experience in mature advanced economies shows that for larger unlisted companies, ignoring the tenets of good corporate governance may be perilous, including an increased prospect of government intervention. Major companies in private hands are still subject to demands for fair treatment by customers and suppliers, even if they may feel no short-term shortage of capital. Also, in the interests of

Principle 5 (Disclosure and Transparency) there would be merit within the corporate governance framework to encourage disclosure of an 'educational' nature to offset the potential dangers of misunderstanding, which can act to the detriment of shareholders and other stakeholders alike. Although this debate may appear somewhat academic at present, with increased attention being displayed towards the valuation of assets on an international basis, it is likely to become of increasing relevance for standard-setters in relation to corporate governance in future.

The Panel in the Report noted that though a strong corporate governance framework is in place for listed companies, there is a need for strengthening the focus on unlisted companies to strengthen the overall system. Accordingly, it recommended that a separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act by the Ministry of Corporate Affairs, which takes into account the interest of stakeholders in such companies. Unlisted companies can voluntarily evolve and adopt a code of corporate governance. Trade associations like CII, FICCI and ASSOCHAM can play an important role in this regard. The Ministry can also consider mandating, in respect of unlisted companies above a particular size, compliance with applicable provisions of Clause 49 of the listing agreement.

It also recommended that the roles and responsibilities of the Ministry of Corporate Affairs should be crystallised in the Companies Act itself, especially in the case of mergers and amalgamations.

The peer reviewer, Sir Andrew Large, felt that increasing pressures are likely to arise for internationally active organisations, listed or unlisted, to abide by higher standards of corporate social governance processes. Therefore, governance processes are likely to rise up the agenda to ensure that this wider 'stakeholder' area is taken seriously by entities. The Panel noted in this regard that there are various laws that recognise the rights of stakeholders. There is a general appreciation in the corporate sector relating to concerns of all stakeholders, and these have been protected adequately under the relevant laws. However, the Panel felt that there is a need for greater disclosure and publicity of CSR (corporate social responsibility) initiatives by the corporate sector; this would put peer pressure on companies inactive in this area. Industry groups and chambers of commerce like FICCI and CII can play an important role in this regard.

The Panel noted that while international practices and developments have apparently been factored into the evolution of corporate governance framework in India, it is essential that learning from the experience of other countries should be a dynamic process and not a static one. The corporate governance code should be constantly reviewed in light of the ever-changing global scenario.

The CFSA notes that recommendations given by the Panel should be considered. These include aspects like disclosure of reasons by listed

The roles and responsibilities of the Ministry of Corporate Affairs should be crystallised in the Companies Act.

companies for non-compliance of non-mandatory requirements, strengthening of risk management in the case of listed companies, the urgent need for the creation of an effective institutional mechanism for time-bound resolution of cases, the need to strengthen the focus on unlisted companies as also the need for greater disclosure and publicity of Corporate Social Responsibility initiatives by the corporate sector.

**5.9.4 Summary**

The present assessment is based on a study of the working of various constituents, namely, the corporate sector (listed and unlisted companies), banking, insurance and public sector enterprises. There is a comprehensive corporate governance framework in India for listed companies and the listing agreement forms an important pillar of the corporate governance framework. However, it also notes that there is a need to strengthen the corporate governance framework for unlisted companies. A number of initiatives have been taken to improve the rights of shareholders. Though there are enabling provisions in place which permit participation of shareholders in general meetings, alternate methods for voting need to be explored coupled with spreading awareness through investors' education. Ownership through cross-holdings and the use of trusts and private companies for owning shares in group companies gives rise to an opaque structure which needs to be addressed.

The quality of corporate governance in the companies in service sector areas like information technology, BPO and finance is a key determinant that affects their ability to attract capital, business, global partners and quality manpower.

Institutional investors need to be encouraged to declare their voting policy and to effectively participate in corporate decision-making.

There is a need to strengthen the existing framework with regard to risk management in the listed companies. To increase the participation of shareholders, more initiatives can be taken: the AGM could be held where majority shareholders reside, alternate methods of voting which are convenient to shareholders could be explored and investor associations can play an active role in providing a platform for co-ordination amongst investors. Institutional investors need to be encouraged to declare their voting policy and to effectively participate in corporate decision-making. There is a need to prescribe an upper limit on the tenure of independent directors. The listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted. They should also be asked to disclose the reasons for non-compliance with non-mandatory requirements.

There is a need to strengthen the enforcement mechanism by focusing efforts on tracking defaulters or non-compliance by the company, which would act as deterrents for future non-compliance and also boost the confidence of investors in the system. Appropriate penalties may be provided for in the law for non-compliance pertaining to related-party transactions. A separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act by the Ministry of Corporate Affairs, which takes into account the interests of stakeholders in such companies. There is a need for greater disclosure and publicity of CSR initiatives by the corporate sector, which would put peer pressure on companies that are inactive in this area.

The adoption of explicit deposit insurance systems around the world has increased since the 1960s.

## 5.10 Safety Net – Deposit Insurance

Deposit insurance is one form of safety net that protects the interests of bank depositors. The first national deposit insurance scheme was the Federal Deposit Insurance Corporation, USA which was created in 1933 during the Great Depression to restore public confidence in the US financial system and to protect small depositors**.** The adoption of explicit deposit insurance systems around the world has increased since the 1960s. According to the International Association of Deposit Insurance (IADI) as of May 1, 2008, 119 countries either have or are considering or planning deposit insurance schemes.[130]

In India, deposit insurance is offered by the Deposit Insurance and Credit Guarantee Corporation (DICGC) which is fully owned by the Reserve Bank. Deposit Insurance is mandatory and covers all banks (commercial/co-operative/RRBs/LABs).[131] All bank deposits[132] are covered by the DICGC. The premium charged for deposit insurance is on a flat rate basis, which is currently 10 paise[133] per Rs.100 of assessable deposits from the year 2004-05 (earlier it was 8 paise per Rs.100 of assessable deposits) with a statutory ceiling on premium at 15 paise. The amount of coverage is presently limited to Rs.1 lakh per depositor and extends to deposits held in the same right and in the same capacity. Given the present limit, as much as 93 per cent of deposit accounts and 60 per cent of assessable deposits were fully protected as of March 2008.[134] The coverage limit as on March 2008 is roughly 2.4 times the per capita GDP against the global average of 3 times per capita GDP.[135] The

As much as 93 per cent of deposit accounts and 60 per cent of assessable deposits were fully protected as of March 2008.

[130] Source: Report on Currency and Finance 2006-08.
[131] Deposit insurance (DI) is not applicable to co-operative banks where the Co-operative Societies Act under which they are registered do not comply with the provisions of Section 2 (gg) of the DICGC Act, 1961. DI has also not been extended to co-operative banks in Meghalaya and three Union Territories (Chandigarh, Lakshadweep and Dadra and Nagar Haveli), which do not have the legal framework in place. The matter is being pursued rigorously with the concerned authorities for carrying out the necessary amendments to their Co-operative Societies Act. There are no co-operative banks at present in Lakshadweep and Dadra and Nagar Haveli.
[132] Except (a) deposits of foreign Governments, (b) deposits of Central/State Government, (c) inter-bank deposits, (d) deposits held abroad and (e) deposits specifically exempted by DICGC with prior approval of the Reserve Bank.
[133] 100 paise = INR 1
[134] Assessable deposits is total deposits less (a) deposits of foreign Government, (b) deposits of Central/State Government, (c) inter-bank deposits and (d) deposits held abroad.
[135] Based on data from 68 countries – Beck (2000).

Deposit Insurance Fund (DIF), built up from the premium received from insured banks and the coupon received from investment in central government securities, accounts for more than 90 per cent of the corpus of DICGC.

An assessment of the deposit insurance system, as operated through the DICGC as a safety net, was undertaken by the Panel on Financial Stability Assessment and Stress Testing. The key issues and their recommendations are summarised in the following paragraphs. The CFSA's observations have been added, where appropriate.

*Organisational Structure*

The DICGC is a fully-owned subsidiary of the Reserve Bank. With the Reserve Bank being the regulator of the banking system, there is a perception of an inherent conflict in the organisational structure. This issue is attempted to be addressed through functional separation of the deposit insurance system from the regulatory operations of the Reserve Bank. While there is a provision for the Reserve Bank to extend a line of credit to DICGC, this cannot per force be an enduring cushion or effective substitute for own funds. If DICGC is to be provided *de jure* independence, the need to build a stand-alone insurance fund assumes importance. The Panel noted that a fund financed solely through premiums paid by insured parties would incentivise the deposit insurance provider to not only perceive a direct stake in the financial health of the insurance system, but also provide motivation for them to scrutinise deposit insurance operations and maintain industry self-policing.

*Flat-Rate Premium versus Risk-Related Premium*

There is a significant element of cross-subsidisation as apparent from claim settlement by the DICGC over the past five years between commercial and co-operative banks. Between 2001-02 and 2007-08, DICGC received 90.5 per cent of its premium from commercial banks, while the share of these entities in claim settlement was a mere 4.3 per cent. In contrast, co-operative banks which paid only 9.5 per cent of the premium were the beneficiaries of 95.7 per cent of the claims settled by DICGC. Further, the trends in claims settlement indicate that the costs of such settlement have only been increasing over time. The Panel felt that the statutory ceiling on the premium of 15 paise per Rs.100 of assessable deposits acts as an impediment in the efforts to strengthen the DIF. In this context, the Panel examined the possibility of introducing a risk-based premium, which may discourage excessive risk-taking by insured banks, motivate them to improve governance and address the issue of cross-subsidisation implicit in the current system.

Stand alone insurance fund is important for DICGC to have *de jure* independence.

The Panel felt that, in India, certain issues need to be factored in before switching over to risk-related premiums, *viz.*, systemic risks posed by big banks and their conglomerates and stabilisation of the supervisory system for the banking sector as a whole. Further, a risk-adjusted premium could prove to be expensive for weak financial entities. Also, the consolidation and restructuring process is underway in the banking sector in certain segments, which may lead to a change in the banks' risk profile. In this context, it felt that legislative amendments to raise the ceiling of flat-rate premium in the interim may be considered.

*Adequacy of the Deposit Insurance Fund*

Sound funding arrangements are critical to the effectiveness of a deposit insurance system and to maintenance of public confidence in it as well as in the banking system. To be effective, a deposit insurance system should include the mechanisms necessary to ensure that adequate funds are available to reimburse depositors promptly if an insured depository institution fails, and to cover the system's operating expenses. Inadequate funding can delay the resolution of failed institutions and significantly increase costs. The design of a deposit insurance system's funding arrangements also will affect when and by whom the costs of deposit insurance are borne. Funding for a deposit insurance system can be obtained on an *ex-ante* or an *ex-post* basis, or through a combination of these approaches. Whether one method is preferred over another will depend, in part, on how the advantages and disadvantages associated with each approach are viewed in the context of the deposit insurance system's design and public-policy objectives.[136]

Funds are provided for deposit insurance systems in many ways – through government appropriations, levies, premia assessed against member banks, Government/market borrowings or a combination thereof. The majority of systems charge *ex-ante* premia as a way to build a fund but retain the authority to charge levies on their members if required by the circumstances of bank failures. Other country systems prefer to rely on *ex-post* levies, *i.e.*, collecting levies from surviving banks to pay the depositors of failed banks after the incidence of failure. In a large number of cases the deposit insurer is provided with the ability to secure funding for liquidity purposes from Governments or its members. The deposit insurance fund (DIF) of DICGC is funded by collection of premia from member-banks (*ex-ante*) and the fund is invested only in Central Government securities. The interest income from such investments and cash recovery of assets of failed banks also contribute to DIF.

Legislative amendments to raise the ceiling of flat rate premium may be considered.

A deposit insurance fund can be built and maintained in two ways. One approach is to employ a steady premium rate over a lengthy period. Alternatively, the premium system can be designed to maintain a target

[136] Funding of Deposit Insurance Systems - Discussion Paper 7 November 2006, International Association of Deposit Insurers, Bank for International Settlements.

reserve ratio or range which should be sufficient to cover the potential losses of the insurer under normal circumstances. Apart from the own source discussed above, the DICGC Act[137] specifies that a line of credit for Rs.5 crore will be available from the Reserve Bank in the event of any shortfall. The RBI Act also provides for extending loans and advances to DICGC, but has not laid down any limit.

The Panel noted that irrespective of fund size, there is always the possibility that the need for funds can surpass the resources, especially in a crisis, which could be filled up by temporarily borrowing from the central bank or by a bail out from the Government directly. In this context, the adequacy of the DIF is an important issue for ensuring solvency of the fund and maintaining public confidence in the deposit insurance system. As at end-March 2008, the total funds available with DICGC for settling future claims, *i.e.*, other than all known liabilities fully provided for (Rs.1,553 crore), was Rs.13,362 crore.

The designated reserve ratio (DRR)[138] as at end-March, 2007 stood at 0.80 per cent. To ascertain the adequacy of the DIF this ratio was subject to stress tests. The stress tests were undertaken based on three scenarios.[139] The results revealed that in the first scenario the estimated liability was Rs.656 crore and DRR reduced to 0.75 per cent. In the second scenario the estimated liability was Rs.10,313 crore and the revised DRR post-stress reduced to 0.05 per cent. In the third scenario the estimated liability was Rs.9,168 crore and the reduced DRR stood at 0.13 per cent.

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[137] DICGC Act, 1961.26 (1) The Reserve Bank shall, from time to time, advance to the Corporation on a request by it such sum or sums as may be required by the Corporation for the purposes of the Deposit Insurance Fund or the Credit Guarantee Fund: Provided that the total amount outstanding at any one time on account of such advances shall not exceed five crores of rupees.(2) The terms and conditions of any advance under this section shall be such as may be determined by the Reserve Bank with the approval of the Central Government.

[138] The percentage of funds available for settling claims to the insured deposits. It stood at 0.74.

[139] **Scenario I**: The average growth in claims settled during the last five years was applied to claims settled for the 2006-07. **Scenario II**: Estimation of insured deposit of all the Grade IV UCBs if they were to be liquidated (Grade IV UCBs: banks meeting the following conditions: (a) CRAR less than 50 per cent of the prescribed limit; (b) net NPL of 15 per cent or more as on March 31 of the previous year). **Scenario III**: If the commercial banks which have been amalgamated (during 2003-2006) with other banks were to be liquidated. The assumptions underlying the analysis are as follows: (i) The liability of the Corporation will grow at a rate estimated on the basis of the past five years; (ii) total insured deposit has been taken as the liability of the Corporation on a particular year; (iii) around 60 per cent of assessable has been taken as the insured deposit, and (iv) while estimating the liability, it is assumed that the assessable deposit and, hence, insured deposit remains constant for the next period as well.

The stress tests reveal that under each of these scenarios, the DICGC would be in a position to meet the claims, although under the latter two scenarios, the DRR would drop sharply. Hence the Panel felt that it would be necessary to constantly monitor the DIF and perhaps, if the situation arises, there will be a need to take a view on the issue of raising the premium in order to strengthen the DIF.

Stress test results show that under some scenarios the DRR, though positive, would decline sharply

*Tax Exemption*

DICGC was exempted from paying income tax up to 1986. Since 1987, it has been paying substantial amounts as corporate tax after computing its income on actuarial basis, the cumulative amount being over Rs.8,600 crore till end-2007, which has led to depletion in the Deposit Insurance Fund. Given that deposit insurance in several countries such as the USA, Japan, Denmark, Brazil, Argentina, Mexico and Chile enjoy full tax exemptions[140] and that DICGC is acting as a trust for the public at large and small depositors in particular, the Panel felt that there is a case for providing exemption from income tax to the DICGC, which could be considered by the Government.

*Failure Resolution*

The Panel acknowledged the importance of DICGC to be taken on board to examine the viability of the regulated entity at the 'entry point' and on an ongoing basis. Accordingly, it felt that a Committee, comprised of the regulatory/supervisory departments of the Reserve Bank and DICGC, be constituted on a standing basis for regular sharing and exchange of information on regulated entities, which will also be useful in times of bank restructuring and/or amalgamations.

Though, as per the DICGC Act 1961, the dues of depositors' are expected to be settled within a maximum period of five months from the date of assuming charge by the liquidator or coming into force of the scheme, the time lag between the issue of a liquidation order and actual reimbursement to the depositor often gets extended owing to various factors, *viz.*, non-receipt of claim lists, delay in appointment of liquidators and court cases. In order to expedite the resolution process, there is merit in considering the need to actively involve the DICGC in the resolution process. To improve the efficacy of the DICGC in the long term, the Panel feels that an 'extended pay box' mandate so as to ensure loss minimisation for the Deposit Insurance Fund could be explored. The CFSA notes, in this context, that some legislative impediments need to be addressed before DIGCC could be made a part of the liquidation process of co-operative banks. Though all eligible co-operative banks as defined in Section 2(gg) of the Deposit Insurance and Credit Guarantee Corporation Act are covered under the Deposit Insurance Scheme, unlike in respect of commercial banks where the DICGC can be appointed as the official liquidator, in the case of co-operative banks the appointment of a liquidator and fixing his remuneration and powers are within the exclusive

There is a case for providing exemption from income tax to the DICGC.

[140] In Canada, although full tax exemption is not available, the premium receipt of Canadian Deposit Insurance Corporation is exempt from income tax.

jurisdiction of the respective State Government since 'co-operative societies' is a state subject under the Constitution. This makes it difficult for DICGC to be a part of the liquidation process in respect of co-operative banks.

Given the present 'pay box' type of mandate, there is a need to improve the recovery performance of liquidated banks so that funds come back to DICGC for re-cycling. As per the provisions of the DICGC Act, of the recoveries realised from the sale of assets of a failed/liquidated bank, after making provisions for expenses, *i.e.*, taxes, dues of workers, salary and other current payments to employees, the balance is required to be paid to the DICGC to the extent of claims paid or provided for. However, some State Governments have disputed the interpretation of this provision of the DICGC Act. The Panel felt that suitable amendment to the relevant provision in the DICGC Act could be enacted, specifying distinct priority to be accorded to the DICGC out of the recoveries so that there is no scope for ambiguity or mis-interpretation.

The Panel noted that Section 43 A of the BR Act provides a certain hierarchy regarding the preferential payment to depositors in the event of winding-up a banking company. These provisions are not applicable to depositors in respect of which DICGC is liable. Likewise, the Companies Act, 1956 also provides priority for certain kinds of debts. There appears to be a lack of clarity regarding the priority of claims of DICGC over that of other claims on an insured bank. Therefore, the Panel felt that it is advisable to make amendments to the DICGC Act to expressly provide that its claims will have priority over those of other creditors during liquidation proceedings. As liquidity proceedings are delayed, depositors are not paid out of the insurance fund in a timely manner.

The issue of whether the DICGC needs to be involved in the resolution process needs to be deliberated upon.

The CFSA notes that the issue of whether the DICGC needs to be involved in the resolution process needs to be deliberated upon. Further, timely winding-up operations of failed institutions would require extensive legal reforms and merely empowering the DICGC may not solve the problem. Hence, it feels that another way would be to delink the settlement of DICGC claims from liquidation when payment to depositors is stopped by the Reserve Bank issuing prohibitory orders against banks. This would also require extensive amendments to the DICGC Act and the BR Act.[141]

[141] This is in line with a recent ruling passed by the National Consumer Commission.

**Summary**

Deposit insurance is a form of safety net to protect the interests of bank depositors. In India, deposit insurance is offered by the Deposit Insurance and Credit Guarantee Corporation (DICGC) which is fully owned by the Reserve Bank. The perception of an inherent conflict in the organisational structure of the DICGC is attempted to be addressed through a functional separation of the deposit insurance system from the regulatory operations of the Reserve Bank. If the DICGC is to be provided *de jure* independence, the need to build a stand-alone insurance fund assumes importance.

The possibility of introducing a risk-based premium was examined. It was felt that a risk-adjusted premium could prove to be expensive for weak financial entities. Also, a consolidation and restructuring process is underway in the banking sector in certain segments, which may lead to a change in the banks' risk profile. In this context, it felt that legislative amendments to raise the ceiling of flat-rate premium in the interim may be considered.

As regards adequacy of funds, it is observed that the deposit insurance fund (DIF) of DICGC is funded by the collection of premia from member-banks (*ex-ante*) and the fund is invested only in Central Government securities. The interest income from such investments and cash recovery of the assets of failed banks also contribute to the DIF. Apart from the own source discussed above, the DICGC Act specifies that a line of credit for Rs.5 crore will be available from the Reserve Bank in the event of any shortfall. The RBI Act also provides for extending loans and advances to DICGC, but has not laid down any limit. There is always the possibility that the need for funds can surpass the resources, especially in a crisis, which could be filled by temporarily borrowing from the central bank or by a bail-out from the Government directly. To ascertain the adequacy of the DIF, stress tests were undertaken based on three scenarios. The stress tests reveal that under each of these scenarios, the DICGC would be in a position to meet the claims, although in some instances the designated reserve ratio would drop sharply. It would be necessary to constantly monitor the DIF and perhaps, if the situation arises, there will be a need to take a view on the issue of raising the premium in order to strengthen the DIF.

Given that deposit insurance in several countries such as the US, Japan, Denmark, Brazil, Argentina, Mexico and Chile enjoy full tax exemptions and that the DICGC is acting as a trust for the public at large and small depositors in particular, it was felt that there is a case for the Government to provide exemption from income tax to the Corporation.

In order to expedite the resolution process, there is merit in considering the need to actively involve DICGC in the resolution process. To improve the efficacy of the DICGC in the long term, an 'extended pay box' mandate so as to ensure loss minimisation for the Deposit Insurance Fund could be explored. Some legislative impediments need to be addressed before the DIGCC can be made a part of the liquidation process of co-operative banks.

There appears to be a lack of clarity regarding the priority of claims of the DICGC over that of other claims on an insured bank and the proposed amendment to the DICGC Act should expressly provide that the claims of the DICGC will have priority over those of other creditors during liquidation proceedings so that there is no scope for ambiguity or mis-interpretation.

The issue of whether the DICGC needs to be involved in the resolution process needs to be deliberated upon. Further, timely winding-up operations of failed institutions would require extensive legal reforms and merely empowering the DICGC may not solve the problem. Another way could be to delink the settlement of DICGC claims from liquidation when payment to depositors is stopped by the Reserve Bank issuing prohibitory orders against banks. This would also require amendments to the DICGC Act and the BR Act.

## 5.11 Review of AML/CFT

### 5.11.1 Introduction

As part of the financial sector assessment, the CFSA decided to include only a review of the status of Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) standards, instead of carrying out a full-fledged assessment as in the case of the other 11 standards. It was accordingly decided that the observance of AML/CFT standards will be reviewed in the light of the assessment done by the Asia Pacific Group in 2005. A Technical Group comprising representatives of the Reserve Bank, SEBI and IRDA undertook the task.

The financial sector in India comprises banking companies/financial institutions, intermediaries in securities market and insurers. The financial sector has been brought under the KYC/AML regime through the enactment of PMLA, 2002 and guidelines issued by the respective regulators for the entities regulated by them. While PMLA has been effective after notification of rules there under on July 1, 2005, the Reserve Bank, SEBI and IRDA have put in place the respective regulatory regime on KYC/AML/CFT.[142] India is a member of the Asia Pacific Group on Money Laundering, which is a Financial Action Task Force (FATF)-Style Regional Body (FSRB), and the latter conducted mutual evaluation of India in regard to its compliance with FATF recommendations in

[142] RBI's circular dated November 29, 2004 – Guidelines on KYC norms/AML standards, RBI's circular dated February 15, 2006 on reporting obligations of banks under PMLA and RBI's circular dated February 18, 2008 requiring banks' overseas branches/subsidiaries to implement the more rigorous of either Indian or host country obligation. The RBI has since issued Master Circular on KYC/AML/CFT on July 1, 2008. SEBI's circular dated January 18, 2006 on AML guidelines and March 20, 2006 on obligations of intermediaries under PMLA. IRDA's circular dated March 31, 2006 on AML guidelines for insurers.

2005. The Report covers five parts, *viz.*, legal systems, preventive measures, institutional and other measures, international co-operation and nine special recommendations especially for the prevention of terrorist financing.

The AML/CFT methodology, 2004 including the assessment criteria is designed to guide the assessment of a country's compliance with international AML/CFT standards as contained in the FATF Forty Recommendations 2003 and the FATF Nine Special Recommendations on Terrorist Financing 2001. Each recommendation has an essential criteria and additional elements.[143] There are four possible levels of compliance: compliant, largely compliant, partially compliant and non-compliant.

**5.11.2 Earlier Assessment**

**FATF Methodology of Assessment and India's Mutual Evaluation by APG in 2005**

The Anti-Money Laundering/Combating Terrorist Financing (AML/CFT) Methodology 2004, including the assessment criteria, is designed to guide the assessment of a country's compliance with the international AML/CFT standards as contained in the FATF Forty Recommendations 2003 and the FATF Nine Special Recommendations on Terrorist Financing 2001 (referred to jointly as the FATF Recommendations). Each recommendation has essential criteria and additional elements. The essential criteria are those elements that should be present in order to demonstrate full compliance with the mandatory elements of each of the Recommendations. The additional elements are options that can further strengthen the AML/CFT system and may be considered as desirable. They are derived from non-mandatory elements in the FATF Recommendations or from Best Practice and other guidance issued by the FATF, or by international standard-setters such as the Basel Committee on Banking Supervision. For each recommendation, there are four possible levels of compliance: compliant, largely compliant, partially compliant, and non-compliant. In certain specific circumstances, a Recommendation may also be rated as not applicable.

**Compliant:** The Recommendation is fully observed with respect to all essential criteria.

**Largely compliant**: There are only minor shortcomings, with a large majority of the essential criteria being fully met.

**Partially compliant:** The country has taken some substantive action and complies with some of the essential criteria.

**Non-compliant**: There are major shortcomings, with a large majority of the essential criteria not being met.

**Not applicable**: A requirement or part of a requirement does not apply, due to the structural, legal or institutional features of a country, *e.g.*, a particular type of financial institution does not exist in that country.

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[143] Essential criteria are those that should be present in order to demonstrate full compliance with the mandatory element of each recommendation and additional elements are optional that can further strengthen the AML/CFT system and are desirable.

Mutual evaluation of India by the Asia Pacific Group (APG) was completed in March, 2005 and the Report, *viz.*, Asia Pacific Group Mutual Evaluation Report, 2005 (APGMER'05) was submitted containing the compliance position of the country. The APG assessment of the financial sector was broadly as under:

(i) FATF Recommendation from Numbers 5 to 25 and SR VII pertain to the financial sector. While the regulatory compliance in regard to KYC/AML guidelines on correspondent banking (R-7); third party introductions (R-9); record keeping by banks as required under PMLA (R-10); operation of shell banks (R-18) and applicability of home country regulations to foreign branches and subsidiaries (R-22) have been rated in the Report as '**Largely Complied**', our guidelines on CDD(R-5); PEPs (R-6); new technologies/non-face to face businesses (R-8); unusual transactions (R-11); STRs (R-13); protection and no-tipping-off (R-14); internal control/compliance/audit(R-15); sanctions (R-17); high-risk countries (R-21); regulation/supervision/monitoring (R-23) have been rated as either partially compliant or non-compliant.

(ii) With a view to attain further compliance with FATF Recommendations, the Reserve Bank has issued fresh/revised guidelines on wire transfers (SR-VII) (circular DBOD.AML.BC. No. 77/14.01.001/2006-07 dated April 13, 2007); on review of risk categorisation of customers by banks at a periodicity of **not less** than once in six months (R-5); periodical updating of customer data (R-5); observance of more stringent regulation by overseas branches/subsidiaries of banks in case of variance in KYC/AML standards prescribed by the Reserve Bank and the host country regulators (R-22); comprehensive guidelines on combating financing of terrorism (CFT)(R-25); screening mechanism for employees (R-15) (circular DBOD.AML.BC. No.63/14.01.001/2007-08 dated February 18, 2008); record keeping of background of unusual transactions (R-11); and STR on attempted transactions and reporting of STRs irrespective of amount and threshold-limit prescribed in PMLA(R-13) (circular DBOD.AML.BC. No. 85/14.01.001/2007-08 dated May 22, 2008).

It had recommended among other things the following:

(i) The Prevention of Money Laundering Act (PMLA) should be brought into force. At the time of the APG Mutual Evaluation Report (APGMER'05), PMLA had not come into effect. PMLA provisions were

made effective after notification of Rules by the Government on July 1, 2005. Hence, the APG MER'05 observation.

(ii) India should work towards full implementation of PMLA offences and encourage investigation/prosecution in the area. It has been observed in Para 60 of APG MER'05 that 'in the PMLA, the predicate offences for money laundering are those listed in the schedule to the Act. These include offences under the Indian Penal Code, (*i.e.*, offences against the state, waging war, murder, ransom, robbery, forgery, *etc.*), the NDPS Act, the Arms Act, the Wildlife Act, the Immoral Traffic Act (people trafficking), and the Prevention of Corruption Act. In some cases the offence only applies where the value involved is Rs.30 lakh or more (approximately US dollar 68,000). In India, offences are not categorised into serious/less serious offences; however, it is clear that not all 'serious' offences are in the schedule to the PMLA. Many of the designated categories of offences in the FATF Recommendations are included, but a number of significant offences are missing, such as organised crime, fraud, smuggling and insider trading. Tax evasion and illegal money value transfer are also not included, as they are civil offences in India. The Government has indicated that their money laundering laws are evolving, and that they may consider expanding the scheduled offences further, as appropriate.' Hence the suggestion for full implementation of PMLA offences in India. It has further been observed in APG MER'05 that there has yet been no prosecution or conviction under the PMLA, and hence the suggestion to encourage investigation/prosecution in the area.

There has yet been no prosecution or conviction under the PMLA.

(iii) Money laundering in PMLA should be a stand-alone offence. It has been observed in Para 59 of APG MER'05 that 'Under Section 3 of the PMLA, money laundering is not a stand alone offence, and therefore a conviction for a predicate offence is required before there can be a conviction for money laundering.' This is because of the definition of 'proceeds of crime' which requires property to be 'related to a scheduled offence'. The Directorate of Enforcement stated that a person could be charged with a predicate and money laundering offence at the same time and the prosecutions could proceed together; however, the conviction for the predicate offence would have to occur before the conviction for money laundering. If a third party has laundered the proceeds of crime, unless that third party is charged for criminal activity relating to a scheduled offence, he cannot be charged for the offence of money laundering. This requirement will cause obvious difficulties in securing convictions for money laundering. Hence, there is the suggestion that money laundering in PMLA should be a stand-alone offence

Money laundering in PMLA should be a stand-alone offense.

(iv) The PMLA offence should be in line with elements of offence in the Palermo Convention. It has been observed in Para 57 of APG MER'05 that 'although the PMLA offence largely covers the requirements of

Article 6 of the Palermo Convention, it appears that it would not extend to the requirement in Article 6(1) (b) (i) – *i.e.*, 'the acquisition, possession or use of property', unless the person was also projecting the property as untainted.' Hence the suggestion to bring it in sync with the Palermo Convention.

(v) 'Fund' should be defined in the Unlawful Activities (Prevention) Act, 1967 (UAPA) in accordance with terrorist financing conventions. It has been observed in Para 71 & 78 of the APGMER'05 that 'The Unlawful Activities (Prevention) Act 1967 (UAPA) was amended in 2004 to criminalise terrorist acts, including raising funds for terrorism. The UAPA does not define the term 'fund'. The Terrorist Financing Convention has a broad definition of fund, and to be fully compliant with the Convention and SRII a country would need to classify funds' in a similarly broad manner. The MHA stated that the intention of the Government is that the term fund where it appears in the Act covers all the aspects of the definition in the Terrorist Financing Convention and that it would be read this way in practice. For the sake of certainty it may be useful for 'fund' to be defined in the Act in accordance with the Terrorist Financing Convention. The definition of 'property' in the UAPA has similarities with the Convention's definition of fund and could add to the argument that 'fund' would be read broadly when read in conjunction with the word 'property'.' Hence the suggestion is to make the definition of 'fund' in UAPA consonant with international standards.

(vi) The FIU should be expressly authorised to obtain additional information from reporting parties and to disseminate the information to appropriate authorities for both domestic and overseas investigation. It should provide adequate training in financial analysis and money laundering investigations to staff so that Reports could be efficiently and effectively processed. It should be able to secure extra funding and to expand manpower, if required. It should establish clear mechanisms for exchange of information with domestic law enforcement agencies and international agencies. It should work with supervisors and regulators of reporting institutions to prepare consistent guidelines to assist in identification of suspicious and unusual transactions. It should maintain comprehensive statistics on currency and suspicious transaction reports.

The FIU should be expressly authorised to obtain additional information from reporting parties and to disseminate the information to the appropriate authorities.

(vii) The law enforcement, prosecution and other competent authorities should maintain an adequate database of statistics to enable review

efficacy of AML/CFT provisions and co-ordinate training for enforcement agencies in relation to AML/CFT.

(viii) PMLA should be amended to cover exchange houses and money remitters. Terminology used in Reserve Bank guidelines should be clarified to ensure consistent language to reflect those elements that are either mandatory or discretionary.

(ix) The authorities should clarify the position on introduced business within the PMLA rules and/or Reserve Bank guidelines, either by stating overtly that third party introductions are not permitted or by defining the terms in which they are possible.

(x) Introduce a consistent requirement between sectors governed by PMLA and RBI guidelines for customer identification and transaction record keeping. Ensure that there are consistent record-keeping requirements under PMLA for the securities sector in keeping with obligations specified by SEBI.

(xi) A general principle should be introduced under PMLA that all covered institutions must have appropriate systems and controls to comply with obligations under the Act. Wherever applicable, require financial institutions that operate overseas branches or subsidiaries to implement more rigorous, either Indian or host country, AML obligations. Introduce a programme for those sectors regulated by SEBI and IRDA to sensitise institutions to specific risks of money laundering and the need for effective systems and controls to mitigate those risks.

**5.11.3 Actions initiated since the Asia Pacific Group Mutual Evaluation Report, 2005**

Some initiatives taken by various regulators since APGMER'05 are as under:

*The Reserve Bank*

| Instructions/guidelines | Made applicable to | With effect from |
|---|---|---|
| KYC/AML guidelines | Scheduled commercial banks | 29/11/04 |
| | Co-operative sector and RRBs | 18/2/05 |
| | Non-banking finance companies | 11/10/05 |
| | Authorised full-fledged money changers | 2/12/05 |
| CTR/STR and record-keeping | Scheduled commercial banks | 15/02/2006 |
| | Urban co-operative banks | 21/03/06 |
| | Co-operative sector and RRBs | 9/3/06 and 3/3/06 respectively |
| | Non-banking finance companies | 5/04/06 |
| Wire transfer | Scheduled commercial banks | 13/4/07 |
| | Urban co-operative banks | 25/5/07 |
| | Co-operative sector and RRBs | 18/5/07 and 21/5/07 respectively |

Source: RBI

PMLA should be amended to cover exchange houses and money remitters.

*IRDA*

The Insurance Regulatory and Development Authority (IRDA) issued anti-money laundering guidelines on March 31, 2006. A number of capacity building initiatives have also been undertaken by IRDA, such as organising a joint meet of Insurance companies' Principal Compliance Officers and FIU-IND to assist insurers in effective implementation of the guidelines on the AML programme and deputing supervisory officials to various seminars/ training on money laundering. Further, life insurance companies were inspected for compliance with AML guidelines, which has resulted in all the inspecting officials being trained on legislative/regulatory requirements of PMLA 2002. Compliance with AML guidelines is planned to be added as a part of the inspection manual of insurance companies to ensure regular and continuous checks on compliance/adherence.

One issue pointed out by the APGMER'05 Report was the absence of reference to the possibility of guidance being issued by the Insurance Regulatory and Development Authority (IRDA) to insurance companies on AML/CFT. IRDA was empowered to issue guidelines under the Prevention of Money Laundering Act, 2002 (PMLA) to the insurance sector and the final framework containing 'Guidelines on Anti-Money Laundering (AML) Programme for Insurers' were issued on March 31, 2006 by IRDA to all regulated insurance companies. By virtue of these guidelines, insurance companies are required to have in place an Anti-Money Laundering Programme that addresses the key requirements of Know Your Customer (KYC) norms, cash/STR and inter-ministerial co-ordination requirements. Compliance with the framework will be monitored by IRDA and co-ordinated through FIU as the central agency under the PMLA.

Guidelines prescribe at a minimum:

- Internal policies, procedures, and controls as AML measures;
- Appointment of a Principal Compliance Officer to effectively discharge the companies' AML Policy;
- Cautious recruitment of employees/agents, and imparting effective AML training to them;
- Internal Control/Audit as an AML control measure.

Compliance with AML guidelines is planned to be added as a part of the inspection manual of insurance companies.

While life insurance companies are required to carry out KYC norms at the time of initial issuance of contract, at the claim payout stage and when additional top-ups are inconsistent with the customers known income

profile, general insurance companies are required to carry out the KYC norms at the payout stage. Insurers' internal policies filed with the Authority form the basis for off-site monitoring of implementation of AML guidelines. One spell of targeted inspection of AML guidelines to check compliance with the requirements of the guidelines and the applicable legislation was carried out in the case of life insurance companies. Issues of non-compliances are being dealt with separately with each of the insurance companies concerned. With India gaining 'Observer' status in the Financial Action Task Force (FATF), assessment of compliance with the recommendations of FATF in the financial sector is in progress.

*SEBI*

SEBI vide its circular dated January 18, 2006 has issued detailed guidelines to securities market intermediaries to establish policies and procedures to combat money laundering and terrorist financing. Securities market intermediaries have been advised to establish procedures for internal control aimed at preventing and impeding money laundering and terrorist financing. This would require registered intermediaries to issue a statement of policies and procedures for dealing with money laundering and terrorist financing; regularly review the policies and procedures on prevention of money laundering and terrorist financing to ensure their effectiveness; adopt customer acceptance policies and procedures which are sensitive to the risk of money laundering and terrorist financing; undertake customer due diligence (CDD) measures to an extent that is sensitive to the risk of money laundering and terrorist financing depending on the type of customer, business relationship or transaction; and develop staff members' awareness and vigilance to guard against money laundering and terrorist financing.

It has also been emphasised that the policies and procedures to combat money laundering should cover the communication of group policies relating to the prevention of money laundering and terrorist financing to all management and relevant staff that handle account information, securities transactions, and money and customer records, whether in branches, departments or subsidiaries; customer acceptance policy and customer due diligence measures, including requirements for proper identification; maintenance of records; compliance with relevant statutory and regulatory requirements; and co-operation with the relevant law enforcement authorities, including the timely disclosure of information. The guidelines also enjoin upon the market intermediaries to have certain clients categorised under the head 'Clients of Special Category' (CSC) which includes Politically Exposed Persons (PEP), non-face to face clients as well as Current/Former Head of State, current or former senior high-profile politicians and connected persons (immediate family, close advisors and companies in which such individuals have an interest or significant influence).

Securities market intermediaries have been advised to establish procedures for internal control aimed at preventing and impeding money laundering and terrorist financing.

SEBI has specified that all registered intermediaries should follow detailed customer due diligence (CDD) measures, such as obtaining sufficient

information in order to identify persons who beneficially own or control securities accounts and verify the customer's identity using reliable, independent source documents, data or information; identify beneficial ownership and control; verify the identity of the beneficial owner of the customer and/or the person on whose behalf a transaction is being conducted; and conduct ongoing due diligence and scrutiny, *i.e.*, perform ongoing scrutiny of the transactions and account throughout the course of the business relationship to ensure that the transactions being conducted are consistent with the registered intermediary's knowledge of the customer, its business and risk profile, taking into account, where necessary, the customer's source of funds. All registered intermediaries have also been advised to develop customer acceptance policies and procedures that aim to identify the types of customers that are likely to pose a higher-than-average risk of money laundering or terrorist financing.

In order to further strengthen Know Your Customer (KYC) norms and identify every participant in the securities market with their respective Permanent Account Number (PAN), thereby ensuring a sound audit trail of all transactions, SEBI vide its circular dated April 27, 2007 has mandated that PAN would be the sole identification number for all participants transacting in the securities market, irrespective of the transaction amount. Market intermediaries have also been advised to put the necessary systems in place so that all individual databases of their clients and client transactions are linked to the PAN details of the client; the database can be used for a detailed analysis and to build the infrastructure necessary for enabling accessibility and queries based on PAN. This would enable the retrieval of all client details, including their transactions.

The formats for reporting suspicious transactions and operational requirements in respect thereof have been specified by SEBI vide circular dated March 20, 2006. The captioned circular also outlines possible transactions which may amount to being suspicious. Compliance with respect to the administration of circulars issued by ISD with regard to anti-money laundering provisions is seen by the respective departments that deal with the regulations governing the functioning of intermediaries.

*Actions taken by the Reserve Bank and SEBI*

The Reserve Bank of India has issued circulars/notifications under Section 35A of the BR Act which empowers them to take action against regulated entities in case of non-compliance. The Reserve Bank, during the

| Table 5.11: Penal Action Taken Against Banks | | |
|---|---|---|
| | 2005-06 | 2006-07 |
| Advisory notices issued | 15 | 4 |
| Show cause notices issued | 17 | 4 |
| Letters of warning issued | 2 | - |
| Penalty amount collected (Rs.) | 110 lakh (12) | 20 lakh (2) |

Figures in parentheses indicate the number of banks
Source: RBI

course of the Annual Financial Inspection of the banks, looks into issues related to KYC and AML and comments on them in their Report. The Reserve Bank has in the recent past taken action against banks that have failed to comply with the guidelines (Table 5.11).

Intermediaries having direct interface with clients have to ensure KYC compliance. During the inspection of DPs by SEBI and depositories, apart from examining the operational aspects of the DP, the area on KYC compliance is also examined. The actions initiated by SEBI based on their inspections are mentioned in Table 5.12 & 5.13:

Financial institutions and intermediaries are required to report cash and suspicious transactions to FIU-IND in their CTR and STR Reports. The details of such Reports are mentioned in Table 5.14:

### 5.11.4 Recommendations

*i)* *Written record of STRs (Recommendation 11 of FATF)* – It requires financial institutions to examine the background to transactions that are complex, unusual or have no apparent economic or lawful purpose and to retain a written record of the examination in line with the underlying transaction record. At present, this is not required under 'Record keeping provisions' of PMLA Rules and suitable amendment is warranted.

*ii)* *Inclusion of money transfer agencies in PMLA ((Recommendation SR VI of FATF)* – Money transfer service providers, such as Western Union, are not currently covered under the PMLA reporting regimen. These agencies are perceived to be high risk-prone in their operations of fund transfers, especially from the viewpoint of terrorist financing. India

| Table 5.12: Inspection of Stock Brokers and Sub-brokers | | | |
|---|---|---|---|
| **Particulars** | **2005-06** | **2006-07** | **2007-08 *** |
| **Orders passed:** | | | |
| Warning - Pursuant to Chairman/Members Orders | 45 | 1 | Nil |
| Suspended | 7 | 32 | 7 |
| Registration cancelled | Nil | 40 | Nil |
| Censure | 34 | 11 | 3 |

* Till December 31, 2007
Source: SEBI

**Table 5.13: Inspection of Depository Participants**

| Year | Adjudication | Enquiry | Warning | Cease and Desist Order |
|---|---|---|---|---|
| 2005-06 | 1 | 1 | 25 | — |
| 2006-07 | 6 | 0 | 17 | 3 |
| 2007-08* | — | — | 8 | — |

* Till November 30, 2007
Source: SEBI

needs to bring these agencies under the PMLA ambit to prevent their misuse for terrorist and other criminal activities.

iii) *STRs – Tipping-Off offence (Recommendation 14 of FATF)* – Tipping off customers after making an STR to the concerned FIU has been made a criminal offence in most countries and FATF Recommendation is also in favour of stringent action in matters of tipping off by STR-making agencies. PMLA Rules require suitable amendments to make tipping off in the case of STRs a legal offence. However, regulatory guidelines of the Reserve Bank already provide that under no circumstances should banks tip off the customer on the STRs related to them.

iv) *STR on attempted transactions (Recommendation SRIV of FATF) -* Under the current STR reporting arrangement, reporting agencies are not required to report STRs on attempted transactions. However, it may

**Table 5.14: Submission of CTRs as at end-March 2008***

| Type of bank | Total |
|---|---|
| Public sector banks | 20,62,742 |
| Private Indian banks | 16,54,749 |
| Private foreign banks | 84,407 |
| Co-operative banks and others | 1,58,015 |
| **Total** | **39,59,913** |

**Submission of STRs as at end-March 2008***

| Type of financial institution | STRs |
|---|---|
| Banking Companies | 1,183 |
| Financial Institutions | 288 |
| Intermediaries | 445 |
| **Total** | **1,916** |

**Source :** FIU-IND Annual Report

happen that having attempted a dubious transaction, the customer may abort or abandon the same due to the fear of STR-reporting by the particular bank/financial institution/intermediary. Reporting agencies should be required to report all such attempted transactions, even if not completed by customers, irrespective of the amount of the transaction. This would facilitate suitable alerts to other agencies with whom the customer may try the same type of transaction. A suitable amendment to PMLA is to be considered by the Government.

The CFSA concurs with the views of the group and suggests that the Reserve Bank/SEBI/IRDA and the Government could consider implementing the aforesaid recommendations.

## 5.12 Concluding Remarks

The financial infrastructure contributes to the effective functioning of institutions and markets and thereby to stability; this serves as the foundation for adequate access to financial services and sustained financial development. In this context, this chapter assesses the legal and institutional frameworks and operational effectiveness of financial policies, both financial supervision and financial infrastructure.

An efficient and robust regulatory structure is an essential prerequisite for the stability of the financial system. Though the current arrangements of the co-ordination among the domestic regulators are thought to be adequate, there is an alternate view that formalisation of HLCCFM with a clear mandate is important in times of crisis for timely and effective crisis resolution. The systemic implications of increased cross-sectoral and cross-border conglomeration of financial companies highlight the need for increased focus on co-ordination and information sharing among regulators. The emergence of the holding company structure and its legal implications has given rise to concerns about their regulation and supervision. The recent international financial turbulence has shown that there is no single fail-proof method of financial regulation and that an ideal system would have elements of both principles-based and rules-based regulation.

There is a consideration that having SROs in the financial sector, albeit with proper safeguards, would add depth and expertise in market operations and reduce the overall cost of regulation. There is a view that formal oversight of SROs is a necessity.

The recent international financial crisis has highlighted the importance of liquidity management for institutions. In this context, it is imperative to have an adequate liquidity infrastructure in place. In the Indian context, active liquidity management has been an integral part of the Reserve Bank's monetary operations and is being achieved through various instruments. However, the use of monetary policy requires to be further honed in order to deal with the impact of external capital flows. Reduction in mandated SLR while taking account of SLR as a prudential requirement, acceptance of highly-rated corporate paper for repo and reverse repo purposes, better cash

management by the Government and capacity building for a better liquidity forecasting model are some of the major requirements. The large funding of Indian markets through the PN route remains an area of concern from the perspective of financial integrity.

Indian Accounting Standards are generally in alignment with International Accounting Standards, except for some modifications to suit local customs, usages and level of development in the country. There has been significant progress in accounting standards; however, some issues remain to be addressed. ICAI needs to be made an autonomous body with its own staff and independent funding. There is a need for developing country - or sector-specific standards where similar standards are not developed by IASB. Attempts need to be made by ICAI to attain convergence with IFRS at the earliest. Given that India has been a member of IASB since its inception, ICAI could contribute actively to the agenda-setting of IASB. There is a need to put in place mechanisms for monitoring compliance with standards and ICAI needs to increase the scope and frequency of training programmes on implementation of accounting standards.

India is one of the earliest countries to have adopted International Standards on Auditing by amending them to suit Indian requirements. There has been significant progress since ROSC-2004; however, there are some areas which need attention. AASB needs to take steps to attain convergence with International Standards on Auditing. It needs to take proactive steps by bringing out more technical guidance and other literature to help small and medium practitioners to understand standards. The functioning of the Quality Review Board should start at the earliest and steps need to be taken to accelerate the process of making the Board of Discipline and Disciplinary Committee functional. The Quality Review Board needs to play a more proactive role as an independent oversight body for the auditing profession in India. The issue relating to non-acceptance of qualified reports from companies needs to be addressed. The principal auditor of the company should have access to the working papers of auditors. There is a need to give functional independence to AASB.

The increased dependence on information technology systems by financial institutions for transactions as well as record maintenance gives rise to a need for proactively managing business continuity. The assessment of compliance to business continuity principles, as applied to select banks, and the payment and settlements systems has indicated that, overall, the systems available in these institutions were in consonance with the requirements.

However, certain issues like outsourcing applications, system maintenance and change control and incident response simulation are required to be monitored more closely from the BCM angle. Continuous upgrading of BCM processes as also capacity building of regulators remain areas to be under constant focus.

A smooth and efficient payment and settlement infrastructure plays an important role in maintaining stability in the financial sector. The CFSA acknowledges that significant progress has been made in improving the payment systems infrastructure in India with the introduction of RTGS, operation of HVCS, setting up of CCIL as the central counterparty in the government securities, foreign exchange and CBLO segments as also setting up CCPs for the settlement of equities and derivatives. The legal framework for payment and settlement systems has also been strengthened by the recent notification of the Payment and Settlement Systems Act and Rules. This has made India largely compliant with international standards and codes in this area. The assessments have, however, highlighted some gaps in the system, particularly with regard to the adequacy of financial resources with CCIL and improving its risk management measures. The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers, thus optimising the use of this infrastructure and achieving greater financial inclusion.

The CFSA notes though there have been improvements in legal infrastructure in the financial sector like setting up of DRTs and the enactment of the SARFAESI Act, the major concern is that, despite the robust insolvency laws, the time taken for completion of liquidation proceedings is one of the highest in the world and the recovery rate one of the lowest.

The time taken for final resolution of the disputes depends on factors, such as number of lenders involved in the dispute, the level of support provided by each of the lenders, and the borrowers' ability to bear the additional cost of rehabilitation/restructuring. In respect of Central PSU/State PSU units, the stand taken by the Government of India/State Governments and labour unions is also important in deciding the time taken for resolution. The stands of labour unions are important in private sector companies also in liquidation proceedings and the legal machinery involved have their own handicaps. These include absence of specialised tribunals to exclusively deal with liquidation/rehabilitation, absence of provisions for appointing liquidators other than Official Liquidators, lack of infrastructure at the Office of the Official Liquidator, delays in determining the claims of workmen and disputes relating to such claims.

The enactment of the Companies Act (Second Amendment), 2002 will address this issue to a large extent. There is also a need to review certain provisions in the Competition (Amendment) Act which are likely to raise issues of regulatory overlap/conflict in future and pose a serious problem to

the stability of the financial sector. The CFSA considers that a separate insolvency regime for banks and other categories of financial institutions is vital in the context of financial stability, as any abrupt handling of insolvency of such institutions will have a serious contagion effect and repercussions across the economic system that will destabilise economic activity.

In India, there is comprehensive corporate governance framework in place for listed companies and listing agreement forms an important pillar of corporate governance framework. There is a need to strengthen the corporate governance framework with regard to risk management in listed companies. Listed companies need to disclose the reasons for non-compliance with non-mandatory requirements. Steps need to be taken to protect the interests of shareholders, such as equitable treatment of all shareholders including minority shareholders and alternate methods of voting which are convenient for shareholders, in which investor associations can play a constructive role. There is a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures and stringent penal action needs to be taken where non-transparent practices are unearthed. Penal provisions for fraudsters may be strengthened in corporate law by providing for disgorgement of gains and confiscation of assets. The corporate governance framework needs to evolve with the changing times and there is a parallel need to strengthen the corporate governance framework for unlisted companies.

The coverage limit of deposit insurance offered by DICGC is comparable to international levels. Stress tests to ascertain the adequacy of the DIF shows that the DICGC would be in a position to meet the claims even under a worst-case scenario. However, the delay in the failure resolution process and the non-involvement of the DICGC in the failure resolution process remain a major concern. In order to enhance the efficacy of the deposit insurance system in India, it is felt that the pros and cons of DICGC's involvement in the bankruptcy process need to be deliberated upon. Alternatively, separation of DICGC claims from liquidation proceedings by an amendment to the BR Act should be considered.

The financial sector has been brought under a robust KYC/AML regime consistent with FATF (40+9) recommendations as applicable to the sector. Legislative framework has been set out in the Prevention of Money Laundering Act, 2002 (PMLA). The respective regulators have issued guidelines for entities regulated by them. While PMLA has become effective from July 1, 2005 on notification of Rules under the Act, the Reserve Bank had

already put in place a regulatory regime on KYC/AML. A number of initiatives have been taken by various regulators in the financial sector based on the findings of APGMER'05, such as issuance of guidelines for submission of CTR/ STR to the FIU and preservation of records, guidelines on wire transfers to banks and guidelines on anti-money laundering programme for insurers. Major areas where action needs to be taken to further strengthen the AML/ CFT practices and align it with international standards are the effective implementation of record-keeping requirements and a robust regime for submission of STRs and inclusion of money transfer agencies in PMLA.

# Chapter VI

# Transparency Issues

## 6.1 Introduction

In the presence of globalisation and integration of financial markets, transparency and public disclosure help in establishing credibility, reducing uncertainity and, hence, in strengthening the effectiveness of policies by the Government, central banks and other regulatory/supervisory agencies. Such transparency is also necessary for the efficient functioning of markets and assessment of country risks. India has made significant progress in recent years in increasing the transparency of monetary policy, financial policies, fiscal policy and data dissemination. In some areas, it has established even higher standards of practice relative to the codes put forth by the IMF in these areas. Recent reforms have given India a modern and well-functioning public policy process that has comprehensive coverage and is couched in a well-articulated, medium-term economic framework. Though the extent of transparency in policy processes has been enhanced significantly, comprehensive data reporting is being undertaken, often exceeding the standards themselves, and there are effective internal and independent external audit controls, there are a few areas where transparency could be improved.

In this chapter, after a discussion of the findings of earlier assessments, the present assessment of the various standards pertaining to transparency, *viz.*, Transparency in Monetary and Financial Policies, Fiscal Transparency and Transparency in Data Dissemination has been put forth with a focus on specific issues thrown up by the assessments of the Advisory Panel. These issues include *inter alia* review of legislations, separation of debt management and monetary management and the role of the Technical Advisory Committee on Monetary Policy (TACMP).

## 6.2 Transparency in Monetary Policy

With central banks switching over to market-based indirect instruments to achieve monetary policy objectives, transparency has gained in importance

as one of the main features of monetary policymaking during the past two decades. In making the objectives of monetary policy public, the central bank enhances the public's understanding of what it is seeking to achieve, and provides a context for articulating its own policy choices, thereby contributing to the effectiveness of monetary policy. Further, by providing market participants with a clear description of the considerations guiding monetary policy decisions, transparency about the policy process makes the monetary policy transmission mechanism more effective, in part by ensuring that market expectations and behaviour move in consonance with the policy stance. By providing the public with adequate information about policy objectives and framework, the central bank can strengthen its credibility by clearly establishing that it is guided by the set framework and, thereby, reduce the risk of policy uncertainity.

The IMF's Code of Good Practices on Transparency in Monetary and Financial Policies identifies transparency practices for central banks in their conduct of monetary policy (Box 6.1). The code focuses on the clarity of roles, responsibilities and objectives of the central bank; the processes for formulating and reporting of monetary policy decisions by the central bank; public availability of information on monetary policy; and accountability and assurances of integrity by the central bank. One of the guiding principles of transparency is that the code, by itself, does not envisage any particular objective or set of objectives for monetary policy. The code also recognises the limits to transparency in the context of market sensitivity to central bank communication.

### 6.2.1 Earlier Assessments

A joint IMF-World Bank team assessed India's compliance with the Code of Good Practices on Transparency in Monetary and Financial Policies as part of the FSAP in 2001. The Report concluded that the transparency practices in monetary policy as they related to the broad principles underlying the Code were satisfactory, and that India had made substantial progress in constituting a transparent framework for monetary policy operations. The Report recommended that transparency could be further strengthened by explicitly specifying the grounds for removal of the head and members of the Central Board of the Reserve Bank. Further, a multiplicity of financial sector regulators increases the importance of a clear demarcation of roles and responsibilities between the different regulatory agencies and of instituting a transparent framework for exchange of information among these agencies.

**Box 6.1: Transparency in Monetary Policy**

The IMF's Code of Transparency in Monetary and Financial Policies (MFP) identifies desirable transparency practices for central banks and financial agencies in their conduct of monetary and financial policies. The code developed by the IMF in 1999 along with the Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies (2000) serves as the reference material for assessing transparency practices in monetary and financial policies. The objective of the code is to allow the authorities to evaluate transparency of their monetary and financial policies, to identify and recommend desirable transparency practices, to provide input on the extent to which transparency practices contribute to policy effectiveness and to monetary and financial stability, to help identify the developmental needs of a country pertaining to transparency issues, and to assist in making informed policy decisions about reforms needed.

The MFP Code is divided into four major sub-groups:

Clarity of Roles, Responsibilities and Objectives of Central Banks: This broadly covers legal clarity on the objectives and institutional framework for monetary policy and disclosure of institutional relationship between monetary policy and fiscal operations.

Open Process for Formulating and Reporting of Monetary Policy Decisions. This covers disclosure of framework, instruments and targets used by central banks, periodic reporting of macroeconomic situations, timely explanation of changes in monetary policy settings, public consultation over proposed changes and disclosure of regulations on data reporting by financial institutions.

Public Availability of Information on Monetary Policy: This envisages adherence to IMF's SDDS/disclosure of balance-sheet and aggregate market transactions on a pre-announced schedule and maintenance of public information services, including an Annual Report.

Accountability and Assurances of Integrity by the Central Bank: This covers disclosure of audited financial statements, public appearances of officials to report on monetary policy conduct and code of conduct for staff.

The Advisory Group on Transparency in Monetary and Financial Policies that released its Report in September 2000 recommended legislative amendment to the RBI Act to give a sharper focus to the objectives of monetary policy. The Group stated that the Reserve Bank should be given a clear and explicit mandate to achieve the objectives of monetary policy. Further, the Group was of the view that it would be necessary to provide, through legislative amendments, reasonable security of tenure to the top management of the Reserve Bank. The Group also recommended that debt management should be separated from monetary management in a phased manner and the Government should set up its own Debt Management Office (DMO). The Advisory Group recommended that the Reserve Bank should set up a Monetary Policy Committee as a committee of the Central Board for formulating monetary policy and stated further that the Government should consider setting out to the Reserve Bank a single objective for monetary policy, *viz.*, to control inflation rate and it should be given instrument freedom and held accountable for attaining this objective.

### 6.2.2 Assessment and Recommendations by the Advisory Panel on Transparency Standards

The Advisory Panel has assessed the status of observance of the transparency code with reference to various principles by elaborately reviewing the situation prevalent in India with respect to the monetary policy framework and the practices associated with transparency. The Panel has, in sum, concluded that the observance of the transparency code in India is comprehensive, *albeit* with a few but important gaps. Of the 46 major principles and sub-principles, 40 are 'Observed', one is 'Broadly Observed' which pertains to specifying the objectives of monetary policy in legislation, three are 'Partly Observed' which pertain to operational independence of the central bank and disclosure of emergency financial support by the central bank and two are 'Not Applicable'. None of the principles were treated as 'Not Observed'. The peer reviewer of the Report on Transparency in Monetary Policy was Sir Andrew Large, former Deputy Governor, Bank of England, who has generally concurred with the observations and recommendations made by the Panel. A summary of the assessment is presented in Table 6.1.

Observance of the monetary policy transparency code in India is comprehensive, but with a few important gaps.

**Table 6.1: Summary Assessment of Transparency in Monetary Policy**

| No. | Area/Practices | Assessment |
|---|---|---|
| **I.** | **Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy** | |
| 1.1 | Objectives and institutional framework of monetary policy to be defined in legislation | PO |
| 1.1.1 | Public disclosure of objectives of monetary policy in legislation | BO |
| 1.1.2 | Responsibilities of the central bank to be defined in legislation | O |
| 1.1.3 | Legislative authority to the central bank to utilise monetary policy instruments | O |
| 1.1.4 | Public disclosure of institutional responsibility for foreign exchange policy | O |
| 1.1.5 | Modalities of accountability for conduct of monetary policy and any other responsibilities to be defined in legislation | O |
| 1.1.6 | Overriding of central bank policies by the government | O |
| 1.1.7 | Legislative clarity on appointment, removal, *etc.* of central bank top management | PO |
| 1.2 | Institutional relationship between monetary and fiscal operations | O |
| 1.2.1 | Public disclosure of conditions for granting credits, advances, or overdrafts to the government | O |
| 1.2.2 | Public disclosure of amounts and terms of credits, advances or overdraft to the government and deposits of the government | O |

| | | |
|---|---|---|
| 1.2.3 | Public disclosure of procedures for central bank participation in primary and secondary markets for government securities | O |
| 1.2.4 | Public disclosure of central bank involvement in the rest of the economy | O |
| 1.2.5 | Public disclosure of allocation of central bank profits and maintenance of capital | O |
| 1.3 | Agency roles performed by central bank on behalf of the government to be clearly defined | O |
| 1.3.1 | Public disclosure of other responsibilities of central bank like fiscal agent to the government and management of foreign exchange reserves | O |
| 1.3.2 | Public disclosure of allocation of responsibilities between the central bank and the government for primary and secondary issues of government securities | O |
| **II.** | **Open Process for Formulating and Reporting Monetary Policy Decisions** | |
| 2.1 | Public disclosure of framework, instruments and targets used to pursue objectives of monetary policy | O |
| 2.1.1 | Public disclosure of procedures and practices governing monetary policy instruments | O |
| 2.1.2 | Public disclosure of rules and procedures for central bank's relationship with counterparties in its monetary operations | O |
| 2.2 | Public disclosure of the composition, structure and functions of a permanent monetary policy-making body | NA |
| 2.2.1 | Public disclosure of advance meeting schedule of the policy-making body | NA |
| 2.3 | Public disclosure of changes in the setting of monetary policy instruments | O |
| 2.3.1 | Public disclosure of main considerations underlying its policy decisions | O |
| 2.4 | Issue of periodic public statements on progress towards achieving policy objectives | O |
| 2.4.1 | Central bank to present policy objectives to public specifying *inter alia* their rationale, quantitative targets, instruments and assumptions | O |
| 2.4.2 | Issue of a report on the evolving macroeconomic situation and its implications for policy objectives | O |
| 2.5 | Public consultations for proposed substantive technical changes to the structure of monetary regulations | O |
| 2.6 | Public disclosure of regulations on data reporting by financial institutions to the central bank | O |
| **III.** | **Public Availability of Information on Monetary Policy** | |
| 3.1 | Central bank data disclosures to be compliant with IMF's SDDS | O |
| 3.2 | Public disclosure of central bank balance sheet on a pre-announced schedule and information on aggregate market transactions | O |
| 3.2.1 | Public disclosure of summary central bank balance sheet on a frequent and pre-announced schedule | O |
| 3.2.2 | Public disclosure of information on central bank's monetary operations on a pre-announced schedule | O |
| 3.2.3 | Disclosure of emergency financial support by central bank | PO |
| 3.2.4 | Public disclosure of a country's foreign exchange reserve assets, liabilities and commitments by the monetary authorities on a pre-announced schedule | O |

| | | |
|---|---|---|
| 3.3 | Central bank to maintain public information services | O |
| 3.3.1 | Central bank to have a publications programme including an Annual Report | O |
| 3.3.2 | Senior central bank officials to explain the institutional objectives to the public | O |
| 3.4 | Public availability of texts of regulations issued by the central bank | O |
| **IV.** | **Accountability and Assurances of Integrity by the Central Bank** | |
| 4.1 | Central bank officials to appear before a designated public authority to report on the conduct of monetary policy | O |
| 4.2 | Public disclosures of audited financial statements of its operations on a pre-announced schedule | O |
| 4.2.1 | Public disclosure of information on accounting policies and independent audit of the financial statements | O |
| 4.2.2 | Public disclosure of internal governance procedures | O |
| 4.3 | Public disclosure of information on expenses and revenues in operating the central bank | O |
| 4.4 | Public disclosure of standards for the conduct of the staff of the central bank | O |
| 4.4.1 | Public disclosure of information about legal protection for officials of the central bank | O |

*Memo Items*

| Assessment | I | II | III | IV | Total |
|---|---|---|---|---|---|
| O | 14 | 10 | 9 | 7 | 40 |
| BO | 1 | – | – | – | 1 |
| PO | 2 | – | 1 | – | 3 |
| NA | – | 2 | – | – | 2 |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Several issues have come up in the Panel's assessment, which have been identified as gaps, and the Advisory Panel has made recommendations pertaining to these issues. The recommendations pertain to providing explicit legislative mandate for objectives of monetary policy after a Working Group comprehensively reviews the current legislation; re-defining and clarifying the responsibilities of the Reserve Bank in regulation and supervision of various institutions in case of overlapping areas with other regulatory authorities; spelling out the criteria for removal of heads and members of the governing bodies of the central bank in the RBI Act; specifying the objectives of exchange rate management; taking on record the directions which the Central Government may give to the Reserve Bank from time to time; with the proposal for separation of debt management from monetary management being mooted, setting up of the DMO as a statute-based entity; changing the

price index for measuring inflation from the present use of Wholesale Price Index (WPI) to an economy-wide Consumer Price Index (CPI) and a Producers' Price Index (PPI) for policy purposes; and enhancing clarity on monetary policy statements by using simpler language.

The CFSA would like to address the proposal for review of legislation and related issues in a more comprehensive manner since similar recommendations have been made by other Panels as well. Similarly, in the CFSA's view, the proposal for hiving off debt management from monetary management and vesting the debt management function with the Central Government raises fundamental concerns from the angle of managing conflicts of interest. This issue also is addressed separately by the CFSA more comprehensively. The CFSA's views on other recommendations of the Panel are briefly set out below:

*Taking on Record the Directions which the Central Government may give to the Reserve Bank from time to time*

In terms of Section 7(1) of the RBI Act, the Central Government may, from time to time, give such directions to the Reserve Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest. This is an issue pertaining to the Reserve Bank's independence in exercising its functions, including monetary policy. Policies of the Reserve Bank need to be consistent with public policy and, where consultations with the Government are needed, the existing formal and informal arrangements for consultations ensure that, in practice, the central bank is *de facto* independent. As in other countries, there is regular dialogue between the central bank and the Central Government. It would be impractical to record such processes of dialogues and consultations. The issue of explicit direction would arise only when there is a difference of opinion between the central bank and the Government and such a direction would have to be in writing. If a written directive is issued in such a situation, the Governor may have to perforce give up his office. On balance, the CFSA feels that it would be impractical to record consultative processes and it is also not desirable to attempt to do so. The peer reviewer has also stated that transparency of process is the best antidote to unwarranted Government interference.

*Role of the Technical Advisory Committee on Monetary Policy*

The Advisory Panel has suggested a review of the role of the Technical Advisory Committee on Monetary Policy (TACMP) with a view to strengthening its functioning, but has not specifically spelt out the way in which this could be achieved. Earlier, monetary policy decisions were taken by the Governor and the Deputy Governor-in-charge of monetary policy. The TACMP was set up in 2005 with a view to strengthening the consultative process in monetary policy, keeping in mind that there may be a move towards collegial decision-making in future. The advice received from the TACMP has been found to be very useful in monetary policy-making. It has, since 2005, already undergone some transformation. To obtain the continued

It would be impractical to record all dialogues and consultations between the Central Government and the Reserve Bank.

benefit of expert opinion, the composition of the reconstituted Committee, to be chaired by the Governor and with the membership of the Deputy Governor-in-Charge of Monetary Policy Department, was expanded in 2007 with the current membership consisting of all other Deputy Governors, two Members of the Committee of the Central Board and external experts in the areas of monetary economics, central banking, financial markets and public finance. The members of the Committee are not appointed on a full-time basis and as such they cannot be made accountable for decisions.

Furthermore, unlike many inflation-targeting countries, no particular decision like setting of a short-term interest rate rests with the Committee. In India, the Reserve Bank achieves its multiple objectives of monetary policy through a variety of measures and instruments like the CRR, open market operations, market stabilisation schemes and prudential measures, all of which form part of the monetary policy framework. As such, it may not be possible for members of the TACMP, who are not full-time members and, hence, not accountable, to vote on a single instrument or a measure to achieve the multiple objectives of monetary policy. As of now, the composition of the TACMP is in the public domain, but discussions and its recommendations are not in the public domain. The CFSA feels that the TACMP as an institution is relatively new (being only about four years old) and the Committee and its role have been evolving since its inception. After careful deliberations, the composition of the Committee has been changed on the occasion of the re-constitution of the Committee and the frequency of its meetings has been increased, as necessary, to suit the needs of the central bank and its policy-making and monetary operations. The policy-making practices of the Monetary Policy Committees (MPCs) in major central banks are discussed in Box 6.2.

The TACMP cannot be given voting rights on policy instruments as the members are not full-time and may have diverse interests.

The CFSA strongly acknowledges the need to explore possible avenues of further transparency in the operations of the TACMP and these are under active consideration in the Reserve Bank, which will be implemented when conditions are suitable. The CFSA felt that one way of further strengthening the TACMP could be by making the proceedings of its meetings public, even if it has only an advisory role. However, unlike members of the decision-making committees in the central banks discussed in Box 6.2, several members of the TACMP are not full-time members. Since they are external and may have diverse interests, they cannot be held responsible for rate-decisions by the Reserve Bank. This is the current situation, but it is likely to evolve. Since there is neither voting nor a single decision-point like setting a targeted rate,

## Box 6.2: Monetary Policy Committees

Since the late 1990s, there has been a growing interest in formulating monetary policy decisions through Monetary Policy Committees (MPC) and the phenomenon has been ascribed to the modernisation of central banks. Recently, it has been noted that decision-making by committees is now the rule rather than the exception in central banks. Thus, collective decision-making is increasingly setting in among central banks across the world.

**The US Federal Reserve's Federal Open Market Committee**

The Federal Open Market Committee (FOMC), established in 1936, formulates monetary policy by setting a target for the federal funds rate on the basis of its assessment of economic activity, inflation, financial market conditions and monetary and credit aggregates. The FOMC is composed of the Board of Governors and the presidents of the district Reserve Banks. Board members (the internal members) are appointed by the President and confirmed by the Senate to serve 14-year terms. Terms on the Board are staggered, with one term expiring on January 31 of each even-numbered year. The President also designates one member of the Board of Governors to be the Chairman and another member to be the Vice-Chairman, each for a four-year term and each subject to Senate confirmation**.** All the members of the FOMC are appointed on a full-time basis and are responsible/ accountable for their actions. The Chairman of the Board of Governors serves as the FOMC Chairman and the president of the New York Fed serves as the Vice-Chairman. The FOMC's decisions are formally made by majority vote among its voting members. The twelve voting members include all seven Governors, the president of the Federal Reserve Bank of New York (a permanent voting member), and four of the presidents of the remaining 11 district Banks. The minutes of the FOMC meeting including the voting record are published three weeks later. The members who voted against the directive are also included in the minutes with an account of the reasons for dissenting. The minutes of the FOMC meeting were not made public before 1994. For enhancing transparency, in 1994, FOMC began formally announcing, immediately after any meeting in which a policy action had taken place, the change in the targeted federal funds rate and a brief rationale for the decision. In 1999, FOMC began a policy of communicating major shifts in its views about future policy even when the current policy setting has not changed.

**The European Central Bank's Governing Council**

The ECB's Governing Council comprises the Executive Board – the president, the vice-president, and four other members (the internal members) – and the governors of the national central banks of the participating countries. Executive Board members are appointed by common agreement among the heads of state of the eurozone for non-renewable eight-year terms. All members are appointed on a full-time basis. No staggering of terms is provided. Governors of participating central banks are appointed locally for at least five years and their terms can be renewed. Until the total number of Governors exceeds 15, each member of the Governing Council has one vote. As of the date when that number exceeds 15, governors will be allocated to two or three groups, the voting rights of which will sum to 15. The Governing Council usually meets twice a month**.** At its first meeting each month, the Governing Council assesses monetary and economic developments and takes its monetary policy decision. At its second meeting, the Council discusses issues related to other tasks and responsibilities of the ECB. While the minutes of the meetings are not published, the rationale behind the monetary policy decision is explained in detail at a press conference held shortly after the first meeting each month. The President of the ECB chairs the press conference.

**The Bank of England's MPC**

The nine-member committee comprises the governor, two deputy governors, two executive directors of the central bank appointed by the governor after consultation with the Chancellor of the Exchequer, and four outside experts (the external members are appointed by the Chancellor). All members of the MPC are appointed on a full-time basis who are accountable for their decisions. The Governors are appointed for fixed renewable five-year terms, while the external members are appointed for renewable three-year terms. A representative from the Treasury also sits with the MPC at its meetings. During its meeting, the MPC takes up a comprehensive review of the economy, including discussions on the budget, money and asset prices, demand and output, the labour market, prices and costs, the world economy and other considerations relevant to its decision. The MPC also reviews the reports prepared by the Bank's regional agents and information available to them from market surveys and polls on expectations about interest rates. At the conclusion of the meeting and for purposes of immediate policy decisions, such as changes in interest rates, the Governor calls upon the members of the Committee to vote for the given proposition. The decisions at the MPC are made by a vote of the Committee, each member having one vote. If there is no majority, the Governor has the casting vote. The representative from the Treasury attends the meeting in a non-voting capacity. The MPC meets on a monthly basis and any decision on interest rates is made by a vote of the Committee and announced immediately, after the Chancellor is notified of the decisions and proceedings of the Committee. The minutes of the meeting are published, along with the details of the recorded notes, on the second Wednesday after the meeting takes place. The Bank is statutorily required to publish a quarterly Inflation Report in which it accounts for the monetary policy actions set out. Through the publication of the minutes and voting at the MPC meetings and the Inflation Report, the Bank is accountable to the public. The names of the members of the MPC for or against a specific cause of action are set out in the minutes.

**References**

Patra, M.D and Samanataraya, A. (2007): 'Monetary Policy Committee: What Works and Where', *Reserve Bank of India Occasional Papers*, Vol: 28, No: 2, Monsoon.

Reserve Bank of India (2001): *Report of the Advisory Group on Transparency in Monetary and Financial Policies* (Chairman: Shri M.Narasimham).

the scope and need for wider dissemination of the discussions leading to such a decision are limited. The CFSA also apprehends that full publicity to the proceedings of TACMP could make members reluctant to express their views and options freely, as has been shown by a recent study of FOMC debates[144]. However, the issue of making public the discussions at the TACMP can be kept under consideration, and can be done when it is considered desirable. The

[144] Meade, Ellen E. and David Stasavage (2008): 'The Dangers of Increased Transparency in Monetary Policymaking', *Economic Journal,* April, pp. 695-717.

strength of the current TACMP is that it has provided an additional and very strong avenue for expert consultations before policy-decisions are taken and that has had a significantly beneficial impact on the outcomes of monetary policy. As mentioned earlier, the TACMP is relatively new and it has worked well so far in its advisory role in monetary policy formulation. The CFSA feels, therefore, that under the current circumstances and given the ambit within which TACMP provides its advice, the need to strengthen the role of the TACMP should be kept in view and practices/procedures towards this goal could be considered as it gains more experience. At that stage, legal implications, including amendments to statutes, should be reviewed.

The views of the peer reviewer, Sir Andrew Large, former Deputy Governor, Bank of England, are in line with the views of the CFSA as he comments that strengthening the mandate of the TACMP beyond being purely advisory could lead to a movement towards a targeted and potentially less flexible monetary policy and a mechanism for accountability of TACMP members would need to be put in place. Such an arrangement is available only in inflation-targeting countries.

*Enhancing Clarity on Monetary Policy Statements by Using Simpler Language*

The CFSA notes that the Reserve Bank has been making all efforts to render the language of policy statements as lucid and comprehensive as possible, so that all categories of readers of the document can understand the import of the rationale underlying the policy measures. However, the CFSA recommends that the Reserve Bank should consider issuing a key to policy statements prepared in simpler and less technical language.

*Price Index for Measuring Inflation*

At present, by convention the WPI is used as the measure of headline inflation for policy purposes, though monitoring of the CPI indexes for industrial workers (CPI-IW), urban non-manual employees (CPI-UNME), agricultural labourers (CPI-AL) and rural labourers (CPI-RL) is also done regularly. The WPI is available on a weekly basis with a lag of about two weeks, thereby enabling continuous monitoring of the price situation for policy purposes and covering a wide range of commodities – primary, intermediate and final consumption goods. One serious limitation of the WPI is that it does not cover prices in the services sector. Given the rising weight of this sector in the GDP, the Advisory Panel has observed that this is a major weakness. The Panel has mentioned that the WPI also includes trade margins which may vary over time and across locations, distorting the estimate of price trends. On this basis, the Advisory Panel has recommended that the Reserve Bank should consider a combination of PPI and an economy-wide CPI, which will come closest to the first best option of using the GDP deflator to measure inflation. The peer reviewer, Sir Andrew Large, has highlighted the difficulty of devising price indicators to include the services sector, and has advised moving with caution on such a move. The CFSA, in principle, agrees with the broad thrust of the Panel's observations that the Reserve Bank needs to consider a move

The strength of the current TACMP is that it has provided an additional and very strong avenue for expert consultations,

from the WPI measure to a CPI measure to capture the headline rate, as is the practice in other countries. This would depend on the timely availability of the CPI, as well as its quality and degree of granularity. The Reserve Bank is of the opinion that the frequency of the WPI should be maintained at the weekly level and not be reduced to monthly, as proposed by the Abhijit Sen Committee because, in India, many data-series which could serve as lead indicators, such as on unemployment rate, labour productivity, capacity utilisation, inflation expectations, and housing prices and volumes, are not available. The weekly WPI data give a feel of the economic dynamics with a shorter lag. Until a system is in place to generate the above-mentioned data to help in monetary policy formulation, giving up the weekly compilation of the WPI is not advisable as it would cause a significant loss of information.

The CFSA notes that though the WPI is used as an indicative measure of inflation for policy purposes, the Reserve Bank, as part of its multiple indicator approach and while evolving an appropriate stance of monetary policy, periodically analyses the inflationary trends in all its dimensions using all available indicators – notably the four measures of occupation-based consumer price indices and derivation of some set of implicit core inflation indicators.

While each of the measures has its advantages as well as weaknesses, the selected measure of inflation should broadly capture the interplay of effective demand and supply forces in the economy at frequent intervals. The coverage of the CPI-IW is broader and the national index is more robust than the other CPI indices, like the CPI for agricultural labourers (AL) and the CPI for urban non-manual employees (UNME). The high frequency of release of the WPI makes it superior to the CPI-IW. Second, the WPI's coverage of commodities is high. While services do not come under the ambit of the WPI, coverage of non-agricultural products is better in the WPI than in the CPI, making the WPI less volatile to relative price changes as against the CPI. The coverage of tradable items, which are essentially manufactured products, is higher in the case of the WPI, whereas the coverage of non-tradables like services pertaining to education, medical care and recreation is higher in the case of the CPI-IW. The WPI is computed on an all-India basis, whereas the CPI is constructed for specific centres and then aggregated to get the all-India index. Because of this feature and since India has a broad common market in commodities making WPI compilation more homogeneous, the WPI is more easily understood by the majority of the public.

The inflation indicator should capture the interplay of effective demand and supply at frequent intervals.

In a large and diverse country like India, with different levels of market participants, there is complexity in conveying the concept of inflation. Given the large difference in consumption baskets in the different occupation groups covered by the CPIs and the large share of food and energy in these baskets, the CPIs do not provide a clear picture about economy-wide inflation. Though the construction of a harmonised CPI, by splicing the various indices suitably, is possible, given the diversity in the underlying of these indices and their coverage (due to factors, such as geography and income level), the harmonised index may not portray correctly the inflationary tendencies in the economy.

A harmonised consumer price index may not correctly portray inflationary tendencies.

Viewed in the context of aiming at monetary policy objectives, it is necessary to obtain a clear understanding of the inflationary process as it has unfolded in recent years, and to assess the nature of shocks impacting the economy and the resulting risks to price stability. The making of monetary policy in India is complicated by variations in the timeliness and reliability of inflation indicators, uncertainity surrounding unobservable variables, such as potential output and gaps and the level of employment, which are intrinsic to policy actions contextual to the state of economic activity. There are also other rigidities related to administered prices, wage-setting procedures, and the large role of supply shocks influencing price indices because of sensitivities to oil and food prices. Knowledge about the relationship between inflation and its determinants remains limited.

Given the diversity in the economic sphere and population characteristics, a combination of different measures of inflation gives useful information on diverse aspects, which is found to be meaningful in formulating an appropriate policy. Hence, both types of indices should be used to monitor inflationary trends. Relying on a single index might result in loss of information in some crucial sectors and might be less useful in tackling the diversity of issues confronting decision-makers. Along with this, as inflation is not targeted in India though price stability is a dominant objective of monetary policy, switching over to the CPI as an inflation indicator is not an immediate imperative. But the CFSA endorses the Panel's view that inflation measurement for policy purposes needs to be improved and strengthened and efforts are already underway on this account at the Central Statistical Organisation (CSO) to prepare an urban and a rural index of consumer price inflation.

*Specifying the Objectives of Exchange Rate Management*

The CFSA observes that the Reserve Bank has been making it clear consistently as part of its policy statements from time to time that its 'exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene, if and when necessary.' The Reserve Bank's interventions in the foreign exchange market are only to contain excessive volatility. The

The Reserve Bank intervenes in the foreign exchange market only to contain excessive volatility.

CFSA is of the view that the policy on exchange rate management is transparently stated and is consistent with current monetary policy objectives. One of the members added that the exchange rate management *per se* should not be an independent goal other than in the context of growth, price stability and financial stability, which should form the primary objectives of monetary policy.

#### 6.2.3 Specific Issues relating to Transparency in Monetary Policy

#### 6.2.31 Review of Legislations

Implementation of several recommendations of the Advisory Panel on Transparency Standards such as providing explicit legislative mandate for objectives of monetary policy, re-defining and clarifying the responsibilities of the Reserve Bank in regulation and supervision of various institutions in the case of overlapping areas with other regulatory authorities and spelling out the criteria for removal of the heads and members of the governing bodies of the central bank in the RBI Act would necessitate a comprehensive review of the current legislation followed by the necessary statutory amendments. The Advisory Panel has felt that, to achieve legislative clarity, there is a need to review the provisions of the RBI Act, particularly with regard to objectives and the mandate specified in the Act on the roles and responsibilities of the Reserve Bank, including its relationship with the Government. The Advisory Panel has accordingly recommended the constitution of a Working Group to comprehensively review the current legislation. The CFSA examined the necessity of the review and the need to constitute a Working Group.

*Clarity of Objectives*

With respect to providing legislative clarity to objectives of monetary policy, the Advisory Panel has indicated that the objectives of monetary policy are not precisely mandated or stated in the RBI Act, as stipulated in the transparency standards framed by the IMF. The Preamble to the RBI Act, enjoins the Reserve Bank to 'regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability and generally to operate the currency and credit system of the country to its advantage.' The CFSA notes that, in the years since the framing of the Act, the various objectives of monetary policy have been derived from these provisions in the Preamble through the interpretations of monetary policy-makers. The major objectives of monetary policy in India have been to maintain price stability and ensure an adequate flow of credit to productive sectors of the economy, which

indicated an implicit and, in recent statements, a more explicit sustainable growth objective. With economic liberalisation, the objective of financial stability has gained importance, apart from several other related objectives, such as maintaining credit quality. More recently, credit delivery and financial inclusion have been added as part of the stance of monetary policy. The interpretations have been changing over time to accommodate the changing circumstances. However, the Reserve Bank has always been transparently articulating its objectives and any change in *inter se* emphasis from time to time through its policy statements. The relative emphasis between the objectives has varied depending on the underlying economic conditions and has been spelt out in every policy statement. The unconventional responses to the recent sub-prime turmoil by the central banks in US, UK and Europe have raised several questions about any rigid monetary policy framework in the context of timely and swift responses required to maintain monetary and financial stability.

Another issue, in this context, has been that of inflation targeting. In the past, the Advisory Group on Transparency in Monetary and Financial Policies (Chairman: Shri M. Narasimham), 2000 recommended that, with a view to moving towards a more transparent system, the Government can unequivocally set out to the Reserve Bank a single objective, say a medium-term inflation objective, and can reset the single objective in the light of evolving developments with Parliamentary endorsement. The Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore), 2006 had also reiterated this view. However, the existing institutional framework has broadly suited the country-specific situation in India, and the flexibility inherent in the present system has served the purpose of achieving monetary policy objectives over the years.

The CFSA, in light of the above analysis, considered the need to define the objectives more precisely. Currently, the objectives as evolved in practice over time fall within the overall objective stated in the RBI Act, and in no way contravene the legislation. On the other hand, the present framework provides enough room and manoeuverability for the Reserve Bank to operate monetary policy suited to evolving needs and circumstances. The multiple objectives with changing relative emphasis *inter se*, combined with the current multiple indicator approach, have stood the test of time and served the country well. The CFSA felt that if the objectives are more stringently framed in legislation, it may not be possible for the Reserve Bank to adapt its policies flexibly, as necessitated by evolving circumstances. In the times ahead, the CFSA feels that, without invoking the unnecessary rigour of a statutory straitjacket, this flexibility of the Reserve Bank to determine the objectives and their relative importance within and consistent with the meaning of the Preamble will be a major factor in helping it conduct monetary policy successfully,

If the objectives are more stringently framed in legislation, it will reduce the Reserve Bank's flexibility.

A recent BIS paper[145] on implementing monetary policy in the 2000s, covering a host of countries in Asia and beyond, reveals that just as monetary policy at the strategic level has undergone significant changes over the years, so has its implementation. At the strategic level, the goals included price stability, growth and competitiveness, and the intermediate targets covered money supply, inflation rate and the exchange rate. While some common themes and practices can be identified, there is no unique 'best' way to implement monetary policy. Central banks everywhere – even in industrialised economies – have continued to refine their operating frameworks and procedures and to innovate where necessary, responding to changing needs and times.

Taking all these factors into account and also the fact that the Reserve Bank has been responding to policy needs in a flexible but fully transparent manner, the CFSA feels that, at the current juncture, significant changes to the statutory basis for defining monetary policy objectives may not be required and the current statutory provisions are flexible and clear enough for the Reserve Bank to define policy objectives and implement monetary operations to fulfill its objectives. Any rigid framework, explicitly incorporated in legislation or mandated otherwise, in the CFSA's view, would reduce this flexibility. However, one member of the CFSA felt that instead of multiple objectives, the Reserve Bank should primarily have the objective of price stability, financial stability and growth.

*Operating Instruments*

Another related question the CFSA would like to address is whether the instruments are adequate to achieve the stated objectives of monetary policy. To achieve its objectives, the RBI Act has provisions relating to the use of various monetary policy instruments such as Cash Reserve Ratio (CRR), Bank Rate, Refinance facilities and Open Market Operations (OMO). The instrument of Statutory Liquidity Ratio (SLR) under the BR Act complements these instruments. The Liquidity Adjustment Facility (LAF) and the Market Stabilisation Scheme (MSS) have evolved within the current legislative framework and are recent additions to the arsenal of the central bank. The Reserve Bank has wide-ranging, statutory powers of extending central bank money as the lender of last resort, including the power of direct discount in crisis situations. It has used most of these instruments flexibly in the past to achieve its monetary stability objectives.

[145] Ho, Corinne (2008): 'Implementing Monetary Policy in the 2000s: Operating Procedures in Asia and Beyond'. *BIS Working Paper No.253*.

A recent amendment to the RBI Act in 2006 has clarified the powers of the Reserve Bank in regard to the use of the repo instrument and has provided more operational flexibility in determining CRR and SLR. Therefore, the CFSA feels that, in the current circumstances, a review of the legislation, in the context of adequacy of policy instruments available to the Reserve Bank for achieving its objectives, is not necessary.

*Regulatory Reach of the Reserve Bank*

In the context of the clarity of the role of the Reserve Bank as a regulator and supervisor, the Advisory Panel on Transparency Standards has observed that the responsibilities of the Reserve Bank in regulating and supervising entities like rural financial institutions, urban co-operative banks, chit funds and *nidhis* are not clearly specified in legislation. There is considerable overlap with the Government and other regulators in this area. The roles and responsibilities of the Reserve Bank as a regulator and supervisor may require clarification in the statute, as they are subject to considerable overlap with those of the Government and other regulators.

For example, there are overlapping areas between the Reserve Bank and the Registrar of Co-operative Societies in the regulation and supervision of urban co-operative banks. The regulation of Chit Funds and *Nidhis* is a shared responsibility between the Reserve Bank and the Registrar of Chits: the Reserve Bank regulates only their deposit-taking activities and interest rates on deposits, while the other aspects are within the regulatory purview of the Registrar of Chits of the concerned States. The Reserve Bank regulates regional rural banks, and rural co-operative banks, but they are supervised by the NABARD[146].

Again, though the powers of the Reserve Bank in regulating the financial markets have been clearly defined under Clause 45 W of Section IIID in the amendment to the Reserve Bank Act in 2006, there is some overlap between the Reserve Bank and SEBI, which arises from the fact that while contracts related to government securities, money market securities, gold-related securities and ready forward transactions come under the regulatory purview of the Reserve Bank, the execution of such contracts on stock exchanges are regulated by SEBI. For example, interest rate futures come under the purview of the Reserve Bank as the underlying is interest rate; however, their trade on the exchange would come under SEBI rules and regulations. Another instance came up when currency futures were launched recently. In such instances, close co-operation between the Reserve Bank and the SEBI needs to be ensured, and is being done.

A review of the legislation pertaining to policy instruments is not necessary.

The Advisory Panel recommended that the multiple responsibilities of the central bank would need to be well-defined and the regulatory and supervisory jurisdictions of the Reserve Bank over varied categories of

[146] This is dealt with in greater detail in the chapters on co-operative and rural banking structure and non-banking financial companies.

institutions and markets need to be given greater clarity and re-definition through amendments in the RBI Act and the BR Act. This should be done with a view to meeting current and future requirements.

The peer reviewer of the Report on Transparency in Monetary Policy, Sir Andrew Large, has stated that to the extent prudential regulation is fragmented away from the central bank, there needs to be a mechanism in place to enable the central bank to be adequately informed and to be able to take on the necessary powers to handle liquidity-related events which appear at times of stress. Further, he added that there would be value, in terms of transparency, in ensuring due clarity of roles and responsibilities, not just of the Reserve Bank but also of agencies with whom the Reserve Bank interacts, in the interests of a robust approach to handling financial stability issues.

With regard to the recommendation to re-define and clarify the responsibilities of the Reserve Bank in regulating and supervising various institutions, as greater recognition and appreciation of the appropriate role of central banks gains ground, it was felt that it may result in further rethinking on the functioning of central banks, especially with regard to the separation of financial regulation and supervision from monetary policy. Such a separation would have resulted in ineffective and inadequate surveillance by the central bank in any crisis similar to the current one, which could prove to be a handicap when the central bank has to provide money urgently to distressed entities under the lender of last resort (LoLR) facility. For example, an amendment to the Reserve Bank Act in 1997 empowered the Reserve Bank to regulate and supervise all categories of NBFCs more comprehensively. This has led to a tightening of prudential measures in this sector in recent years and there has been some harmonisation of NBFCs' regulations with those pertaining to commercial banks. Accordingly, the Reserve Bank has greater information and flexibility in regulating and supervising NBFCs than in many other countries. This is useful to the Reserve Bank in handling financial stability issues. The current scenario, especially in advanced economies, has mainly arisen as the non-banks were not covered under the prudential supervision of the central bank.

'There needs to be a mechanism in place to enable the central bank to be adequately informed and to be able to take on the necessary powers to handle liquidity-related events which appear at times of stress.' – Sir Andrew Large.

Some objectives of monetary policy such as credit delivery, credit quality and financial inclusion require prudential measures and the related question is whether the Reserve Bank has enough powers to complement purely monetary measures with prudential measures as and when needed.

The CFSA observes that though the Reserve Bank was set up in 1935 under an Act of 1934, with basic functions of note issue, bankers' bank, reserve management and banker and debt manager to Governments, the areas of regulatory and supervisory jurisdictions of the Reserve Bank have expanded over time, through other legislations as also a series of amendments to the RBI Act, giving it powers of supervision over a wide range of institutions and markets. As regards market regulation, while traditionally the Reserve Bank has been regulating money, foreign exchange and government securities markets, legal clarity has been established through an amendment to the RBI Act. Along with this expansion, the presence of the Government and the setting up of other regulators such as SEBI, IRDA and PFRDA have resulted in a situation where the regulators have come to acquire generally divided but some overlapping responsibilities across institutions and markets. To remove such overlapping areas which lead to diffusion of regulatory powers, the Advisory Panel has recommended re-defining and clarifying the responsibilities of the Reserve Bank in regulation and supervision of various institutions in the case of an overlap with other regulatory authorities.

The problem of overlapping areas in regulatory authority needs to be rectified.

The CFSA observes, in the above context, that despite the overlapping responsibilities, sufficient legislative authority is available with the Reserve Bank to discharge its regulatory/supervisory functions. Apart from a series of amendments to the RBI Act, the Reserve Bank has been entrusted with the supervision of India's banking system under the provisions of the BR Act. The regulation over foreign exchange market was acquired through FERA, 1973 and modified by FEMA, 2000. With the notification of the Payment and Settlement Systems Act, 2007 the Reserve Bank has the legislative authority to be the regulator and supervisor of the payment and settlement systems. Consequent upon amendments to the RBI Act from time to time, the regulatory powers of the Reserve Bank have been extended to NBFCs and select all-India financial institutions.

The Reserve Bank has also been regulating money, foreign exchange and government securities markets through its regulatory and supervisory powers provided in several legislations. Under Section 16 of the Securities Contracts (Regulation) Act, 1956 (SCRA), the Government notified in 2000 that contracts for sale and purchase of government securities, gold-related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities would come under the regulatory purview of the Reserve Bank. In addition to SCRA, the power of the Reserve Bank to regulate markets is derived from the BR Act and FEMA. The amendments to the RBI Act in 2006 brought clarity with regard to the Reserve Bank's regulation over financial markets in money, foreign exchange, gold-related securities, government securities and related derivatives products. In the BR (Amendment) Act, 2005 which is pending before Parliament, it has been proposed that (i) only co-operative societies that have been licensed by

Sufficient legislative authority is available with the Reserve Bank to discharge its regulatory/ supervisory functions.

the Reserve Bank should be allowed to carry on the business of banking; (ii) the primary co-operative societies should be given a timeframe within which they have to either stop the business of banking or fulfill all the requirements specified by the Reserve Bank and obtain a license to carry on the business of banking; and (iii) the Reserve Bank will have the powers to order a special audit of co-operative banks in the public interest for more effective supervision of co-operative banks.

The above analysis shows that though all of its powers are not derived from a single legislation, collectively there is no ambiguity about its role, functions and powers with institutions and markets. The Reserve Bank has also been given additional powers through amendments to the RBI Act as well as other financial legislations, and any need for additional powers may not need an overhaul of the present legislative framework, but can be addressed through amendments as required.

To address any remaining overlapping responsibilities, which may at times be inevitable under the present framework of divided responsibilities among multiple regulators, a mechanism for inter-regulatory co-operation exists and the CFSA agrees that this mechanism can be further strengthened in the context of maintaining financial stability and supervision over growing financial conglomerates. This is addressed elsewhere in this Report.

The CFSA, however, felt that it may not be possible to remove the overlap in financial regulation and supervision *vis-à-vis* the Government, as the roles of the Government in this respect are based on the Indian Constitution. For example, 'co-operation' is a subject on the State List in the Indian Constitution and the State Governments, being the representatives of the people, derive their powers over the co-operative bodies from this List for enhancing financial inclusion, which would be difficult to override in any way. Acknowledging that grey areas exist in this particular area, the CFSA felt that they can be resolved through discussions/consultations, rather than through segregating responsibilities into watertight compartments. Similar to the regulation of NBFCs, the Reserve Bank has taken several steps to strengthen the financial sector, such as tightening monetary conditions, providing dynamic provisioning norms in a counter-cyclical manner and instituting the Task Force for Urban Co-operative Banks (TAFCUB) in the urban co-operative banking sector, despite legal and constitutional issues.

It may not be possible to remove the overlap in financial regulation and supervision *vis-à-vis* the Government.

For example, to address the dual control of UCBs, the CFSA notes that the Reserve Bank has taken a realistic response to the prevailing legislative

situation. Considering the need for innovative responses and constant vigilance, the Reserve Bank has entered into MoUs with State Governments on a voluntary basis to constitute the TAFCUB that is comprised of representatives of the State Government, federation of UCBs and the Reserve Bank, thus establishing a consultative approach to regulation and supervision of the UCBs. It may not be useful and would be time-consuming to remove the overlapping areas rooted in the country's legislative and constitutional framework. The CFSA feels that the more pragmatic solution to the problem of overlap is to work around the problem and solve it through alternative arrangements that are compatible with the current legal dispensations, as is currently being done. Evolving rules/regulations to carry on the functions granted by the regulatory legislations for products and market intermediaries, such as primary dealers, brokers, trading platforms and settlement procedures and self-regulatory organisations would go a long way in clarifying and resolving grey areas of overlap.

Taking these into account, the CFSA felt that there was no further requirement for a thorough review of the RBI Act or other legislations to re-define and clarify the responsibilities of the Reserve Bank in regulation and supervision of various institutions. The CFSA recommends, however, that if necessary, further amendments could be considered to the BR Act to bring it in alignment with modern banking and financial practices, as recommended by the Advisory Panel on Financial Stability Assessment and Stress Testing.

On the recommendation of the Panel that the proposed amendment of the RBI Act should include specific language that the Reserve Bank nominees will not serve in any regulated entity, *e.g.*, any bank, the CFSA felt that though the presence of such representatives may be avoided in normal circumstances, they may be required to be placed on the boards of regulated entities in the case of re-structuring, moratorium and other exceptional circumstances emanating from weakness of the entities. Hence, the legal provision, as an enabling provision for the presence of such representatives, may be maintained. It is pertinent to note here that in the recent credit crisis in the financial markets, several central banks and Governments in the US and Europe had to do varying degrees of intervention to take over or bail-out banks and financial institutions and have had to put their representatives on the boards of the banks in some cases.

*Operational Independence of the Reserve Bank*

Yet another angle from which a review of the Reserve Bank legislation is sought is with regard to *de jure* independence of the Reserve Bank. In the context of popular public perception of the Reserve Bank's independence, the Advisory Panel has observed that Section 11 of the RBI Act specifies that the Central Government may remove from office the Governor, or a Deputy Governor or any Director or any member of the Local Board and, as per Section 30 of the RBI Act, also supersede the Reserve Bank Board. However, the procedure and grounds for removal of the Governor, or a Deputy Governor are

There is no further requirement for a review of the RBI Act.

not specified in the Act nor are the procedures and grounds for supersession of the Reserve Bank Board. Hence, the Advisory Panel has recommended that it would be desirable to consider suitable amendments to the relevant provisions of law, making it obligatory on the part of the Government to make public the procedure and reasons for removal of the Governor/Deputy Governors from office and supersession of the Board.

The CFSA, however, observes and concurs with the view expressed by the Advisory Panel on Financial Regulation and Supervision that, as per convention, the Reserve Bank enjoys independence *vis-à-vis* the executive arm of the State. In practice, through conventions, agreements and MoUs in specific areas, the Reserve Bank has gained, over time, a greater degree of operational independence in performing its monetary policy function. Also, since its constitution in 1935, there has hardly been any occasion for the abrupt removal of the Governor[147]/Deputy Governors or supersession of the Board, as such actions are fraught with serious reputation risks. The CFSA apprehends that by specifying procedures and reasons for the removal of the Governor/Deputy Governor as also for the supersession of the Reserve Bank Board there is a potential for loss of the Reserve Bank's well-established *de facto* independence. Hence, this issue, according to the CFSA, does not provide sufficient grounds for a detailed review of the Reserve Bank legislation. The peer reviewer, Sir Andrew Large, has also stated that improvements in the transparency of process will in itself enhance the operational independence of the Reserve Bank. There has been consistent evolution of the practices and functions of the Reserve Bank, either within the existing legislative framework or by suitable amendments. A thorough overhaul of the legislation would be difficult to implement as has been the experience in the case of the review of the Companies Act, which has been going on for more than 10 years. However, one member of the CFSA felt that though the system of achieving operational autonomy through *de facto* means rather than *de jure* means has worked well so far, situations might arise when the independence and autonomy of the Reserve Bank may be circumscribed by the executive. To guard against such eventualities, the member recommended that all the issues relevant for securing *de jure* independence of the Reserve Bank may be considered for formalisation.

'Improvements in the transparency of process will in itself enhance the operational independence of the Reserve Bank'

– Sir Andrew Large

[147] Shri Benegal Rama Rau, Governor (1949-1957) resigned from the post on account of differences with the Finance Minister over one of the supplementary taxation proposals that envisaged an increase in the stamp duty on bills under the bill market scheme (Ref: *The Reserve Bank of India: 1951-1967, Vol. 2*). Shri K.R.Puri, Governor (1975-1977) was removed from his post, presumably for strong political affiliations (Ref: *The Reserve Bank of India: 1967-1981, Vol. 3*).

In sum, from the foregoing analysis, the CFSA is of the view that any modifications required to strengthen the monetary policy as also the regulatory framework might be carried out by necessary amendments to the existing legislations as needed, which would not call for a fundamental review of legislations or an overhaul of the existing legal framework.

**6.2.32 Separation of Debt Management from Monetary Management**

The issue of conflict between the debt management and monetary management functions of the Reserve Bank has received considerable attention in the last ten years. The general recommendation for separation of debt management from the monetary authority is essentially premised on the perception of a conflict of interest between monetary policy and debt management because of the conflicting pressures on the direction of interest rates. It is felt that separation of debt management from monetary management would ensure that the conduct of monetary policy is not circumscribed by the need to conduct efficient debt management. At different times this could necessitate manoeuvring monetary policy so that the borrowing programme is completed successfully by undertaking policy decisions on interest rate changes to reduce debt servicing costs and creating a conducive liquidity environment to facilitate easy market borrowing. The preclusion of the Reserve Bank from participating in primary issues of government securities, under the Fiscal Responsibility and Budget Management, Act 2003 has provided greater maneuverability to the Reserve Bank in containing monetised deficit. For furthering the functional independence of the Reserve Bank, the Advisory Panel has recommended that the Debt Management Office (DMO), as announced in the Annual Budget for the year 2007-08, should be set up as a statute-based entity. However, the peer reviewer Sir Andrew Large has stated that any move towards an independent DMO would increase the importance of making available information to the Reserve Bank on all matters that could affect financial stability. There will be a necessity to ensure adequate, immediate and continuing channels of communication between the proposed DMO and the Reserve Bank.

The RBI Act mandates the Reserve Bank to act as a debt manager of the Central Government and it also enables it to do debt management for the States through agreements. Various groups set up by the Reserve Bank since 1997 have recommended separation of debt management from monetary management function and hiving off debt management function to an independent entity [notably the Committee on Capital Account Convertibility (1997), the Advisory Group on Transparency in Monetary and Financial Policies (2000) and the Committee on Fuller Capital Account Convertibility (2006)]. A similar recommendation was made by the Report of the High-Powered Expert Committee on Making Mumbai an International Financial Centre (Chairman: Shri Percy Mistry) and, more recently, in the Report of the Committee on Financial Sector Reforms (Chairman: Prof. Raghuram Rajan) brought out by the Planning Commission. The Report of the Internal Working

Group set up by the Ministry of Finance to further the implementation of the budget announcement on DMO has recommended the establishment of a statutory body to perform debt and cash management in India. It has envisioned an agency that will manage debt for the Centre and the States, with the objective of meeting their financing needs, while minimising borrowing costs within acceptable levels of risk. It has also proposed a draft Bill to create a National Treasury Management Agency (NTMA).

The Reserve Bank had, in its Annual Report in 2000-01, mentioned about the separation of the functions of debt management and monetary management and also referred to the recommendations made by a Working Group for the establishment of a company under the Indian Companies Act to take over the debt management function. In the Annual Policy Statement, 2001-02 announced in April 2001, the decision to separate the two functions was considered desirable in principle subject, however, to three pre-conditions, *viz.*, development of financial markets; reasonable control over fiscal deficit; and necessary legal changes. With the passage of the FRBM Act, there is clearly a commitment to proceed in the direction of fiscal rectitude. The FRBM Act precludes the Reserve Bank's participation in the primary issues of government borrowing, thus obviating the scope for any automatic and direct monetary financing of fiscal deficits and simultaneously, the Reserve Bank can no longer modulate its monetary policy through direct intervention in the primary market. The basic source of conflict of interest has, thus, been already removed. Considerable progress has been made in terms of development of financial markets. Further, the Government securities market has matured considerably with a transparent issuance mechanism, robust settlement infrastructure and wider participant base. The price discovery in the primary issues is market-driven and the real-time dissemination of trade information ensures transparency in the secondary markets, though markets are still prone to some bouts of illiquidity.

In recognition of the recommendations made by the various committees mentioned above, in his Budget speech of 2007-08, the Finance Minister announced the Government's intention to set up a DMO:

'World over, debt management is distinct from monetary management. The establishment of a Debt Management Office (DMO) in the Government has been advocated for quite some time. The fiscal consolidation achieved so far has encouraged us to take the first step. Accordingly, I propose to set up an autonomous DMO and, in the first phase, a Middle Office will be set up to facilitate the transition to a full-fledged DMO.'

In line with the recommendation of an internal expert group of the Central Government in May 2001, the Government of India is proceeding with the establishment of a Middle Office for public debt management as a prelude to the setting up of a full fledged DMO.

The CFSA notes that the Government is in favour of proceeding with the setting up a full-fledged DMO for the following reasons:

First, with the passage of the FRBM Act, which preludes the Reserve Bank's participation in the primary debt issues of Government, the basic source of conflict of interest has been removed. However, it is felt that there is an additional conflict of interest with respect to the impact on the economy. Monetary policy influences interest rates for the entire economy. When the Reserve Bank has to also maximise the Government's objectives of low funding costs as its debt manager, it could have a bias in favour of lower interest rates and thus higher inflation, thereby affecting its monetary policy-making. In the interest of prudent macro-economic and fiscal management it is better for the Government to adopt a responsible fiscal policy and face the real market cost of funding.

Second, at present the stipulations with respect to mandatory investment by insurance companies, provident funds, and the like in government securities, along with the requirements for banks to investment in 'SLR' (government) securities, helps the Government to finance its fiscal deficit at costs that are perhaps lower than they would otherwise be. These mandatory requirements could also inhibit the natural development of the bond market that could otherwise take place. As the economy and financial markets develop over time, such requirements can be expected to come down. Government debt issuance and management will then need more intense engagement with the market participants and with investors, in particular. Professional competence in a DMO will then be absolutely necessary.

Third, at present the Reserve Bank harmonises the functions of debt management and foreign exchange intervention (*e.g.*, through issuance of MSS) in the interest of preserving financial stability. There are concerns that such harmonisation may become difficult if the DMO is separated from the Reserve Bank. This issue can be addressed in the design of the DMO, and, as suggested by the peer reviewer, it will be necessary to ensure adequate, immediate and continuing channels of communication between the proposed DMO and the Reserve Bank. Besides, the issuance of MSS need not necessarily be seen as a permanent feature of Indian foreign exchange management.

Fourth, the development of the securities market has to be a collective effort between the Government, and all the financial market regulators. It can be argued that the two roles of providing price and financial stability and of developing markets should be separated. Mixing the two roles can lead to inadequate or tardy development of the government securities market.

Fifth, as far as staffing issues are concerned, the DMO can hire from the Reserve Bank and from the market. Given the conditions in the financial market, the latter would not be too difficult. Though there have been difficulties in setting up new Government authorities, there is no reason to fear setting up a professional body like the DMO.

Finally, competition may improve public debt management. The States should be given a choice of debt managers; they can remain with the Reserve Bank or move to the DMO.

The Chairman, CFSA while fully concurring with the current proposal for the setting up of a Middle Office, which is akin to the role of the DMO in the US Treasury, personally viewed that the setting up of an independent DMO and the decision regarding complete separation of debt management from the Reserve Bank need to be revisited for the following reasons:

First, the consolidated fiscal deficit of the Centre and States will continue to be close to 6 per cent of GDP, even after attainment of the current FRBM targets, which would be among the highest level of fiscal deficit in the major economies in the world, coupled with an extremely high level of overall Government debt to GDP ratio, which is in excess of 80 per cent of the GDP. At such levels of fiscal deficit and debt to GDP, there will be continuing need for ensuring overall consistency in fiscal and monetary management in the foreseeable feature.

Second, the BR Act provides for the stipulation of SLR, which is a prudential monetary policy instrument and it also ensures a certain level of participation by banks in the government securities market. Until the consolidated fiscal deficit of the Government comes down even further, enabling a reduction in the SLR, SLR will continue to be an important parameter in the banks' functioning for quite some time to come. Hence, management of government debt, regulation of the banks and monetary policy will continue to be inter-twined.

Third, in a situation of volatile capital flows, sometimes as excess inflows and other times as outflows, foreign exchange intervention from the Reserve Bank is necessary on a relatively continuous basis. For consequent sterilisation through issuance of MSS or its reverse, the co-ordination of the debt management with these operations will need to continue. In 2007-08, the volume of issuance of securities under MSS had been comparable to those issued for the market borrowing programme. In 2008-09, there has been

significant unwinding. Separation of the DMO from the Reserve Bank will make it very difficult to harmonise these operations as is done at present.

Fourth, on the issue of conflict of interest, in the current Indian context where 70 per cent of the banking assets remain in the public sector banks, setting up of a DMO under the Ministry of Finance may, in fact, exacerbate the conflict between Government's role as a debt manager and its status as the owner of a substantial portion of the banking sector. In such a situation, the Government can bring in undue influence on the public sector banks to buy government securities in auctions and, thereby, could distort the price discovery process and emergence of a market-based, risk-free yield curve. This could eventually undermine the very edifice of the microstructure of the government securities market which has been so carefully and assiduously built up over a period of time. Since the Government in its capacity as the major stakeholder of banks can, theoretically, influence their investment decisions, unless robust corporate governance standards are put in place, the transparency of debt management would be the first casualty. In fact, the Tarapore Committee conditioned its recommendation for separation of debt management from the Reserve Bank with the prior privatisation of banks.

Fifth, government debt management requires further development of the government securities market through both institutional and market development activities including diversification of debt instruments, development of derivatives and widening of the investor base. Thus, there is a continuing need for these activities to be co-ordinated by the Reserve Bank in such a way that monetary and financial stability is maintained along with such financial deepening in the government securities market.

Sixth, the Reserve Bank also acts as the debt manager for State Governments. Consequent to the recommendation of the Twelfth Finance Commission, the Central Government no longer acts as an intermediary for State Government borrowings. There has also been an increase in the volume of State Government debt issuance. In such a situation, it will become increasingly important to harmonise the market borrowing programme of the Central and State Governments. Hence, separation of the Central Government DMO will make such harmonisation difficult. Furthermore, it may not be appropriate for a Central Government authority to also do State Government debt management.

Seventh, the responsibility for overall debt – both internal and external – rests with the Central Government which has to frame policies pertaining to external debt and internal liabilities other than market borrowings. In this context, the setting up of a Middle Office in the Ministry of Finance to frame overall policies pertaining to debt management would facilitate an integrated approach to debt management. However, the Reserve Bank could continue to conduct all market borrowing operations as the agent of the Government, in a fashion very similar to the functions of the Federal Reserve Bank of New York on behalf of the US Treasury.

Eighth, as a practical issue, it has always been difficult to set up new Government authorities. The experience in setting up infrastructure regulatory authorities like Telecom Regulatory Authority of India, Tariff Authority of Major Ports and Central Electricity Regulatory Commission, and financial sector regulators like SEBI, IRDA and PFRDA has thrown up a number of issues. Problems have arisen, with respect to staffing of these institutions and the operation of the government rules in their service. The consequence has been that these institutions have been staffed to a significant extent by the officers on deputation from different government departments making it difficult to develop appropriate expertise. A similar problem will arise if a separate DMO is attempted to be set up under the direct control of the Government.

Finally, the Reserve Bank is able to handle the debt management operations in view of the large size of its staff and expertise developed in managing regulation and supervision of the banks, money market operations and debt market operations. The staff of the DMO will need to be conversant with financial markets and also be able to interact with market players continuously. Moreover, technical infrastructure for issuance, trading, *etc.*, will also have to be set up, which will involve avoidable expenses. It may be noted that because of these considerations, almost all debt management operations of the US Treasury are carried out by the New York Fed, while the DMO in the US Treasury mainly acts as a Middle Office.

Thus, while acknowledging that there could be potential conflicts in objectives and operations between debt management and monetary management and, therefore, for effective discharge of both, functional separation could eventually be desirable, the Chairman personally felt that the time is not yet ripe for the complete separation of debt management from the Reserve Bank, although a well-structured Middle Office could help debt management, as a whole.

### 6.2.4 Summary

While India is largely compliant with the international standards and codes in respect of transparency in monetary policy, some of the major issues and recommendations made by the CFSA in this regard pertain to the following:

The Reserve Bank has multiple objectives of monetary policy with changing relative emphasis combined with the current multiple indicator

approach, which has been reasonably effective. A legislative amendment to specify the objectives of monetary policy is not considered necessary at this juncture. Any modifications that might be required to strengthen the monetary policy as also the regulatory framework might be carried out by necessary amendments to existing legislations as needed.

The issue of explicit direction by the Government would arise only when there is a difference of opinion between the central bank and the Government, and such a direction would have to be in writing. It would be impractical to record regular consultative processes and it is also not desirable to attempt to do so.

Specification of any rigid procedure and reasons for the removal of the Governor/Deputy Governor as also for supersession of the Reserve Bank Board could be counter-productive.

The TACMP, which is relatively new, is undergoing changes over time. Further strengthening of the TACMP can be done as it gains more experience.

The issue of conflict between the debt management and monetary management functions of the Reserve Bank has received considerable attention in the last ten years. Various Groups set up by the Reserve Bank have recommended separation of these two functions and hiving-off debt management function to an independent entity. In recognition of these recommendations, the Finance Minister announced the Government's proposal to set up an autonomous DMO and, in the first phase, setting up of a Middle Office to facilitate a transition to a full-fledged DMO. The CFSA notes that a well-structured Middle Office within the Ministry of Finance could help conduct both internal and external debt management and ensure better risk management. The Government is in favour of proceeding with the setting up of a full-fledged DMO. While acknowledging that there could be potential conflicts in objectives and operations between debt management and monetary management and, therefore, for effective discharge of both, functional separation could eventually be desirable, the Chairman personally felt that the time is not yet ripe for the complete separation of debt management from the Reserve Bank, although a well-structured Middle Office could help debt management as a whole.

Given the economic and demographic diversity that exists in India, a combination of different measures of inflation gives useful information on diverse aspects, which is found to be meaningful in formulating an appropriate policy. Relying on a single index might result in loss of information regarding some crucial sectors and might be less useful in tackling the diversity of issues.

## 6.3 Transparency in Financial Policies

### 6.3.1 Benchmark

The assessment of India's transparency practices in financial policies relate to the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies (Box 6.3). Though the four broad areas covered in the Code, *viz.,* clarity of roles, responsibilities, and objectives; the process for formulating and reporting policy decisions; public availability of information; and accountability and assurances of integrity, are common to both, the sub-criteria differ for the assessment of monetary policy transparency and transparency in financial policies.

Therefore, the Panel has made separate assessments for transparency in monetary policy and transparency in financial policies. Taking into account the fact that the Reserve Bank is the sole regulator and supervisor of banking and non-banking supervision, the government securities market and deposit insurance, the present exercise assessed the Reserve Bank's adherence to the code of good practices on transparency in financial policies for these four sectors. The assessment of transparency practices as relevant to the government securities market has been undertaken for the first time by this Panel. For securities market regulation, the policies of the SEBI were assessed

**Box 6.3: Transparency in Financial Policies**

The IMF's Code of Transparency in Monetary and Financial Policies identifies desirable transparency practices for central banks and financial agencies in their conduct of monetary and financial policies.

Clarity of roles, responsibilities and objectives of financial agencies: covers legal clarity on the objectives and institutional framework including responsibilities and procedures for appointment of top management of financial agencies and disclosure of institutional relationship between financial agencies and calls for transparency practices to govern SROs.

Open Process for formulating and reporting of financial policies: covers disclosure of regulatory framework, financial reporting, fees, information-sharing arrangements and policy changes.

Public availability of information on financial policies: covers public reporting of major developments in the sector, disclosure of aggregate data on a timely basis, disclosure of balance sheet information of financial agencies and disclosure of oversight of consumer protection arrangements.

Accountability and assurances of integrity by financial agencies: covers disclosure of audited financial statements, public appearances of officials to report on financial policies, standards for conduct of staff.

and, for regulation of insurance, the policies of the IRDA were assessed. The assessment has also covered the transparency practices of an SRO, *viz.,* the Foreign Exchange Dealers' Association of India.

### 6.3.2 Earlier Assessments

A joint IMF-World Bank team assessed India's compliance with the Code of Good Practices on Transparency in Monetary and Financial Policies as part of the Financial Sector Assessment, and the Report was released in May 2001. The Report covered transparency practices of: i) the Reserve Bank for Banking Supervision; ii) SEBI for regulation and supervision of Securities Markets; and iii) DICGC as regards Deposit Insurance.

The Report observed that the disclosure practices of the Reserve Bank as regards banking supervision and SEBI for securities markets were satisfactory. However, the disclosure practices of DICGC were not considered satisfactory. The Report concluded that the presence of several financial sector regulators increases the importance of a clear demarcation of roles and responsibilities between the different regulatory agencies and of instituting a transparent framework for exchange of information among these agencies.

The Advisory Group constituted by the Standing Committee on International Financial Standards and Codes set up by the Reserve Bank in 1999 to assess the observance of standards and codes relevant to Transparency in Monetary and Financial Policies recommended that the regulatory/supervisory authorities could introduce a practice of disclosure of adverse supervisory action.

A review of the implementation of the recommendations of the Advisory Group undertaken by the Reserve Bank in 2004 noted that, while the extant monetary and financial policy formulation, procedures and practices have by and large worked well for the country, further improvements in autonomy, accountability and transparency are possible, to further improve the efficacy of the central bank policies.

### 6.3.3 Assessment and Recommendations by the Advisory Panel on Transparency Standards[148]

Most financial sector regulatory laws in India appear to be formulated in favour of transparency. In this regard, the laws governing the Reserve Bank, SEBI and IRDA are observed to provide the required degree of operational transparency. The provisions relating to criteria for removal of heads were more transparent in respect of SEBI and IRDA. The findings regarding financial transparency practices were quite favourable. No significant weaknesses were identified with respect to banking supervision, securities supervision or insurance supervision, while the shortcomings in the deposit insurance scheme were relatively minor. A summary of assessment is given in Table 6.2)

No significant weaknesses were identified with respect to banking supervision, securities supervision or insurance supervision.

The shortcomings in financial transparency practices in the deposit insurance scheme were relatively minor.

[148] On transparency in financial policies, the CFSA did not have the benefit of a peer reviewer.

**Table 6.2: Summary Assessment of Transparency in Financial Policies**

| No. | Area/Practices | Assessment | | |
|---|---|---|---|---|
| | | RBI | SEBI | IRDA |
| **V.** | **Clarity of Roles, Responsibilities and Objectives of Financial Agencies** | | | |
| 5.1 | Objectives and institutional framework of financial agencies to be defined in legislation | O | O | O |
| 5.1.1 | Public disclosure of broad objectives of financial agencies in legislation | O | O | O |
| 5.1.2 | Public disclosure of responsibilities of financial agencies and authority to conduct financial policies | O | O | O |
| 5.1.3 | Public disclosure of modalities of accountability for financial agencies | O | O | O |
| 5.1.4 | Public disclosure of procedures for appointment and removal of members of the governing bodies of financial agencies | PO | O | O |
| 5.2 | Public disclosure of relationship between financial agencies | PO | O | O |
| 5.3 | Public disclosure of role of payment systems | O | NA | NA |
| 5.3.1 | Public disclosure of policy principles by agencies overseeing payment systems | O | NA | NA |
| 5.4 | Public disclosure of relationship between financial agencies and SROs | O | O | O |
| 5.5 | SROs performing regulatory and supervisory functions to be guided by same good transparency policies as specified for financial agencies | O | O | NA |
| **VI.** | **Open Process for Formulating and Reporting of Financial Policies** | | | |
| 6.1 | Transparency in conduct of policies by financial agencies | O | O | O |
| 6.1.1 | Public disclosure of regulatory framework and operating procedures governing conduct of financial policies | O | O | O |
| 6.1.2 | Public disclosure of regulations for financial reporting | O | O | O |
| 6.1.3 | Public disclosure of regulation for the operation of organised financial markets | O | O | NA |
| 6.1.4 | Public disclosure of structure of fees charged by financial agencies to financial institutions | O | O | O |
| 6.1.5 | Public disclosure of procedures for information-sharing and consultation between financial agencies | PO | O | O |
| 6.2 | Public disclosure of significant changes in financial policies | O | O | O |
| 6.3 | Issue of periodic public reports on how policy objectives are pursued by financial agencies | O | O | O |
| 6.4 | Public consultations before proposed substantive technical changes to the structure of financial regulations | O | O | O |

| | | | | |
|---|---|---|---|---|
| **VII.** | **Public Availability of Information about Financial Policies** | | | |
| 7.1 | Issue of a periodic public report on the major developments of the sectors of the financial system by financial agencies | O | O | O |
| 7.2 | Public reporting of aggregate data related to jurisdictional responsibilities on a timely and regular basis | O | O | O |
| 7.3 | Public disclosure of balance sheet on a pre-announced schedule and information on aggregate market transactions | O | O | O |
| 7.3.1 | Public disclosure of emergency financial support by financial agencies | PO | NA | NA |
| 7.4 | Financial agencies to establish and maintain public information services | O | O | O |
| 7.4.1 | Financial agencies to have a publications programme including a periodic report on their principal activities | O | O | O |
| 7.4.2 | Senior officials to disclose institution's objectives and performance to the public | O | O | O |
| 7.5 | Public availability of texts of regulations and other directives issued by financial agencies | O | O | O |
| 7.6 | Public disclosure of deposit insurance schemes and other client asset protection schemes, its procedures and performance | O | O | NA |
| 7.7 | Public disclosure of information on consumer protection arrangements | O | O | O |
| **VIII.** | **Accountability and Assurances of Integrity by Financial Agencies** | | | |
| 8.1 | Officials of financial agencies to appear before a designated public authority to report on the conduct of financial policies | O | O | O |
| 8.2 | Public disclosures of audited financial statements on a pre-announced schedule | O | O | O |
| 8.2.1 | Public disclosure of information on accounting policies and independent audit of the financial statements | O | O | O |
| 8.2.2 | Public disclosure of internal governance and internal audit procedure | O | O | NO |
| 8.3 | Public disclosure of information on operating expenses and revenues | O | O | O |
| 8.4 | Public disclosure of standards for the conduct of the officials and staff of financial agencies | O | O | O |
| 8.4.1 | Public disclosure of information about legal protection for officials of financial agencies in the conduct of official duties | O | O | O |

*Memo Items:*

| **Assessment** | **RBI** | **SEBI** | **IRDA** |
|---|---|---|---|
| O | 32 | 33 | 29 |
| BO | – | – | – |
| PO | 4 | – | – |
| NO | – | – | 1 |
| NA | – | 3 | 6 |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable; NO – Not Observed.

The recommendations of the Advisory Panel relate to the criteria for removal of the heads and members of the governing bodies of the Reserve Bank; relationship, information-sharing and consultation between financial agencies; the role of oversight agencies with regard to payment systems; disclosure of information on emergency financial support by financial agencies; information on consumer protection arrangements (such as dispute settlement processes); disclosure of internal governance procedures

including internal audit arrangements and review of data/information disclosure.

The CFSA largely endorses the assessment and recommendations of the Advisory Panel with regard to the various financial agencies, *viz.*, the Reserve Bank, SEBI and IRDA. However, there are two major overlapping issues which require separate discussion. First, while the SEBI Act, 1992 and IRDA Act, 1999 lay down the circumstances under which the Central Government can remove the Chairman and members of their respective boards, the grounds for removal of the head and members of the Central Board of the Reserve Bank are not specified in the RBI Act. This issue of statutory specification of criteria for removal of the heads and members of the Reserve Bank has been addressed earlier in the section under 'Review of Legislation' in the discussion on transparency in monetary policies. The second issue pertains to the necessity of institutionalisation of relationships and co-ordination among regulatory agencies.

**6.3.31 Lack of Transparency in Financial Markets**

The development of new financial instruments, like complex derivative instruments, whose value, price and ownership are difficult to ascertain and new financial institutions, like hedge funds, private equity, and SIVs with little or no regulation has led to lack of transparency in financial markets. Lack of information and disclosure to both market participants and to relevant regulators has led to loss of investor confidence. The Financial Development Report, 2008 of the World Economic Forum noted that the recent turmoil in financial markets has been caused partly by the lack of transparency in financial markets, as investors could not properly price the new instruments and assess the overall losses faced by financial institutions. The Report has highlighted that greater transparency, including fair value accounting, along with prompt recognition by financial institutions of their exposure and losses, are essential to restore investors' confidence in financial markets.

**6.3.32 Relationship, Information-sharing and Consultation between Financial Agencies**

One key issue addressed by the Panel relates to the relationship, information-sharing and consultation between financial agencies. The relationship between the main regulatory bodies is not defined in the statute but the jurisdictional issues of the regulatory bodies are often disclosed in notifications published in the Official Gazette. At present, co-operation and

information-sharing between the Reserve Bank and other regulatory agencies is handled by a formal standing committee. The Government, by an executive order, has set up a High Level Co-ordination Committee on Financial Markets (HLCCFM) consisting of the Governor, the Reserve Bank, Chairman, SEBI, Chairman, IRDA, Chairman, PFRDA and the Finance Secretary, Central Government. The Committee has further constituted three technical committees under the jurisdiction of the Reserve Bank, SEBI and IRDA to report on matters which have a bearing on the financial and capital markets. However, it is found, in practice, that though the meetings of the apex Committee – the HLCCFM – are held regularly, those of the technical Committees are not and the exchange of information is often not adequate or timely. The absence of such co-ordination might pose risks to systemic stability. Free, frank, regular and institutionalised exchange of information between all the regulators has become an imperative in the Indian financial system. The Panel has recommended that this arrangement needs to be institutionalised and brought under a formal and transparent arrangement. The CFSA acknowledged that because the regulatory regime has undergone certain fundamental changes in India, such as from being a government-dominated financial system to a market-oriented one, new regulators like those for pension, insurance and the capital market have been created. Also, for greater efficiency, the focus on regulation/supervision has changed from micro to macro and from on-site to more off-site, and the issue of regulatory co-ordination has become increasingly crucial.

The CFSA notes that the arrangements, as they stand today, have been put out in the Reserve Bank's policy statements, website and publications, as they were brought into being, and developments pertaining to their functioning have also been put in the public domain. Hence, the arrangements have been transparently and formally disseminated. The CFSA, however, felt that further institutionalisation and formalisation of the co-ordination arrangements might turn out to be counter-productive as they would take away the freedom and flexibility which are necessary for the formulation and implementation of financial sector policies. The CFSA, therefore, views the current arrangements as adequate since they have served the test of time by maintaining systemic stability through inter-regulatory co-ordination, and no further stringent formalisation of arrangements would be necessary. What matters is the quality and knowledge of the regulatory authorities and not the institutionalised structure of the interaction between them. However, the CFSA recommends that modes of achieving greater exchange of information in a need-based and timely manner may be explored and put in place, as appropriate[149].

Free, frank, regular and institutionalised exchange of information between regulators is critical.

With regard to co-operation with overseas regulators, SEBI has been entering into MoUs for regulatory co-operation, mutual assistance and sharing of information with overseas securities markets' regulatory

[149] This issue has also been discussed in Chapter 5, Section 5.2 on Regulatory Co-operation.

authorities. IRDA does not have any such arrangement. In respect of international agencies, a need-based information-sharing mechanism is in place in the Reserve Bank and the Panel has recommended that this mechanism can be publicly disclosed. The CFSA feels that issues relating to inter-regulatory co-ordination with overseas regulators have increased in importance in view of the enhanced need for supervision of cross-border financial intermediaries in the context of greater capital flows. While global financial integration through such intermediaries does have a beneficial impact, the volatility in capital flows can cause instability at critical times, especially in an emerging market economy like India, if they reflect changes in the risk appetite of international investors rather than a country's fundamentals.

The CFSA's views on the other recommendations of the Panel, as they relate to specific agencies, are set out below.

**6.3.33 The Reserve Bank of India**

The Advisory Panel has highlighted two major financial policy transparency issues. It recommended that, as there is no system of disclosing aggregate data of emergency financial support by way of provision of liquidity (of the nature of LOLR) extended by the Reserve Bank to banks under exceptional and unforeseen circumstances, it would be appropriate from the organisational view-point and also from the transparency angle if such information is placed in the public domain after a suitable period. Since this practice is in place in many central banks, and has been advocated by the IMF as well, the CFSA endorses the view of the Panel, while emphasising that the data can be provided only on an aggregate basis with a suitable lag.

The Advisory Panel also recommended that the Reserve Bank needs to establish a formal independent mechanism to resolve disputes arising out of government securities market transactions and investor complaints, and also disclose the mechanism for the settlement of disputes. In this connection, the CFSA notes that one of the functions of FIMMDA is to act as an arbitrator for settling disputes between its members. At present, the disputes in the government securities market are attended to by FIMMDA for their members. But FIMMDA's powers of dispute resolution are circumscribed by the fact that it is not a recognised SRO, and the Reserve Bank does not have a mandate for issuing directions to FIMMDA in this regard. An arbitration mechanism in stock exchanges is currently operative in respect of SEBI-regulated markets. The Financial Industry Regulatory Authority in the US, which is an SRO under

the Securities Exchange Act and responsible for the regulation of all securities firms, operates an arbitration forum for resolution of disputes between its members. The CFSA recommends that a formal dispute resolution mechanism may be put in place in the government securities market.

**6.3.34 Securities and Exchange Board of India**

The Advisory Panel recommended that SEBI, stock exchanges and other regulators should invest in technology to ensure that all the information they receive from companies, market intermediaries (such as brokers), and mutual funds be treated as public goods and disseminated instantaneously to the public at large without privileges to any special bodies. Embargos for data releases, if any, should be for a specified time period and exceptions, if any, to this stance on information dissemination should be explained on the official website of the regulator. The CFSA endorsed the view of the Advisory Panel.

**6.3.35 Insurance Regulatory and Development Authority**

Internal governance and internal audit procedures of IRDA are, at present, not publicly disclosed. The Advisory Panel recommended that IRDA should consider placing this information in the public domain in line with the public disclosure of internal governance procedures and internal audit arrangements by the Reserve Bank and SEBI through their respective Annual Reports and, in the case of the Reserve Bank, in the publication 'Functions and Working' of the Reserve Bank. The CFSA endorses the view of the Advisory Panel.

**6.3.4 Summary**

The three major regulators in the financial sector, namely, the Reserve Bank, SEBI and IRDA were assessed by the Panel on Transparency Standards for compliance with the IMF's Code of Good Practices on Transparency in Financial Policies. Some of the major issues and recommendations arising out of the assessment are listed below:

There is a need to achieve greater exchange of information between the regulatory agencies in the financial sector in a timely manner to maintain systemic stability. However, further institutionalisation and formalisation of the existing co-ordination arrangements through the HLCCFM might be counter-productive, as they would take away the freedom and flexibility necessary to formulate and implement financial sector policies.

Further formalisation of the co-ordination arrangements could become counter-productive, as they would detract from freedom and flexibility.

As there is no formal dispute resolution mechanism in the government securities market, such a system may be put in place.

## 6.4 Issues Relating to Fiscal Transparency

**6.4.1 Benchmark**

The IMF's Code of Good Practices on Fiscal Transparency, 1998 as updated in 2001 and revised in 2007 has been used by the Panel to assess the fiscal transparency of the Government (Box 6.4). The Code emphasises

**Box 6.4: IMF's Code of Good Practices on Fiscal Transparency**

The *Code of Good Practices on Fiscal Transparency* was brought out by the IMF in 1998. The Code was updated in the year 2001, and further revised in 2007, reflecting recent global financial developments. The IMF's Code emphasises transparency in the structure and functions of Government at different levels, fiscal policy formulation, implementation and monitoring, public sector accounts and audit, fiscal projections and assessment of fiscal risks.

The Code comprises the following four pillars:

Clarity of Roles and Responsibilities: Comprises two core practices on the clear distinction between Government and commercial activities and envisages a clear legal framework governing fiscal administration. The pillar also covers issues related to contractual arrangements between the Government and either public or private operators.

Open Budget Processes: Covers core practices on transparent budget preparation, execution, and monitoring. The elements in the second pillar include the requirement of adequate time for legislative consultation, and an emphasis on the importance of transparency in the quality of the assumptions and realism of the overall budget, as well as on the presentation of final audited accounts to the legislature.

Public Availability of Information: Emphasises the importance of publishing comprehensive fiscal information. The pillar contains a list of information requirements that may be found in either budget documentation or other fiscal reports, and encompasses a number of practices related largely to the provision of information. The pillar also covers long-term assessments.

Assurances of Integrity: Deals with the quality of fiscal data and the need for independent scrutiny of fiscal information.

transparency in the structure and functions of Government at different levels, fiscal policy formulation, implementation and monitoring, public sector accounts and audit, fiscal projections and assessment of fiscal risks.

**6.4.2 Earlier Assessments**

Fiscal transparency was assessed earlier in an Advisory Group Report and the Report on Observance of Standards and Codes (ROSC) in 2001 and a Review Report in 2004. All these assessments mainly covered the Central Government. The major issues addressed by the Reports related to: reporting of general government finances and information on contingent liabilities, quantification of quasi-fiscal activities, simplification of inter-governmental fiscal relations, strengthening of expenditure framework by clearly distinguishing between current and capital spending, adoption of uniform budgetary practices at the state-level, reporting of information about

government equity and loans to public enterprises and reporting of methods used for revenue forecasting.

The FRBM Act, 2003 and Rules, 2004 have brought in a rule-based fiscal regime which addresses many of the issues raised by earlier assessments.

### 6.4.3 Assessment and Recommendations by the Advisory Panel on Transparency Standards

The Indian federal structure comprises three levels of Government, *viz.*, the Centre, States and local bodies. The functional responsibilities and *inter se* relationships among different tiers of Governments are governed by constitutional provisions. While a comprehensive assessment of transparency should encompass all levels of Government, because of lack of information, local bodies have not been covered by the assessment; even the second tier of State Governments could not be assessed individually, but an assessment at the aggregate level has been attempted by the Advisory Panel, for the first time. Going forward, future assessments must endeavour to cover all levels of Government in a comprehensive manner, and the CFSA believes that implementation of various recommendations made by the Panel would facilitate such an expansion in scope. Besides an assessment of compliance with regard to the IMF's Code and recommending appropriate steps for convergence, the Panel has addressed several special issues in the Indian context that are germane to greater transparency. The CFSA emphasises that Governments at all levels should earnestly address these issues. The peer reviewer of the Report on fiscal transparency, Mr Vito Tanzi, former Fiscal Affairs Director, IMF has fully endorsed the observations and recommendations of the Panel. He acknowledged that significant progress has been made in promoting fiscal transparency, both at the Central as well as at the State-level.

As regards compliance to the IMF Code, the Central Government is assessed as having 'Fully Observed' or 'Broadly Observed' 40 out of 45 practices in the four areas of assessment. On five practices, the assessment is partly observed and in none of the practices was there non-observance. The State Governments have depicted a relatively lower level of observance, but still a significant number of 28 out of 45 practices were either 'Fully' or 'Broadly Observed'. The 'Partly Observed' practices numbered 15 and non-observance was assessed against two practices in respect of Pillar III (Public Availability of Information). The CFSA concludes that fiscal transparency is significantly observed both in the Centre and the States. Also, institutional developments, particularly of the enactment of Fiscal Responsibility and Budget Management legislation (FRL) by the Central Government in 2003 and by 26 out of 28 State Governments between 2002 and 2007, have significantly contributed to greater fiscal transparency since the ROSC in 2001. But, overall, the current status of compliance still leaves room for the substantial improvement that is needed for greater transparency. A summary assessment is provided in Table 6.3.

| Table 6.3: Summary Assessment of Fiscal Transparency | | | |
|---|---|---|---|
| No. | Area/Practices | Assessment | |
| | | Centre | States |
| **I.** | **Clarity of Roles and Responsibilities** | | |
| **1.1** | **Distinguishing the government sector from the rest of the public sector and rest of the economy** | | |
| 1.1.1 | Clarity in structure and functions of government | O | O |
| 1.1.2 | Fiscal powers of executive, legislative and judiciary to be well-defined | O | O |
| 1.1.3 | Relationship and responsibilities of different levels of government to be clearly specified | PO | PO |
| 1.1.4 | Clarity in relationships between the government and public corporations | O | PO |
| 1.1.5 | Clarity in government's relationships with the private sector | O | PO |
| **1.2** | **Clear and open legal, regulatory, and administrative framework** | | |
| 1.2.1 | Comprehensive budget, tax, and other public finance laws for collection and use of public funds | O | O |
| 1.2.2 | Clarity of laws and regulations related to the collection of revenues | O | BO |
| 1.2.3 | Time for consultation about proposed laws and regulatory changes | O | O |
| 1.2.4 | Clarity in contractual arrangements between the government and public or private entities | O | O |
| 1.2.5 | Legal basis for government's liability and asset management | O | O |
| **II.** | **Open Budget Processes** | | |
| **2.1** | **Timetable for budget preparation** | | |
| 2.1.1 | Budget calendar should be specified and adhered to | O | O |
| 2.1.2 | The annual budget should be realistic, and prepared and presented within a comprehensive medium-term macroeconomic and fiscal policy framework | O | BO |
| 2.1.3 | Description of major expenditure and revenue measures | O | BO |
| 2.1.4 | Assessment of fiscal sustainability and clarity on assumptions about economic developments and policies | BO | BO |
| 2.1.5 | Clear mechanisms for the co-ordination and management of budgetary and extra-budgetary activities within the overall fiscal policy framework | O | O |
| **2.2** | **Clear procedures for budget execution, monitoring, and reporting** | | |
| 2.2.1 | The accounting system should provide a reliable basis for tracking revenues, commitments, payments, arrears, liabilities, and assets | PO | PO |
| 2.2.2 | Presentation of timely midyear report on budget developments to the legislature | O | BO |
| 2.2.3 | Presentation of supplementary revenue and expenditure proposals during the fiscal year to the legislature | O | O |
| 2.2.4 | Presentation of audited final accounts and audit reports to the legislature | O | O |
| **III.** | **Public Availability of Information** | | |
| **3.1** | **Public disclosure of information on past, current, and projected fiscal activity and major fiscal risks** | | |
| 3.1.1 | Budget documentation to cover all budgetary and extra-budgetary activities of the Central Government | O | O |

| | | | |
|---|---|---|---|
| 3.1.2 | Disclosure of forecasts and sensitivity analysis for the main budget aggregates for at least two years following the Budget | PO | PO |
| 3.1.3 | Nature and fiscal significance of Central Government tax expenditures, contingent liabilities, and quasi-fiscal activities to be part of the budget documentation | PO | PO |
| 3.1.4 | Receipts from all major revenue sources, including resource-related activities and foreign assistance, should be separately identified | O | O |
| 3.1.5 | Publish information on the level and composition of debt and financial assets, significant non-debt liabilities, and natural assets resource | O | PO |
| 3.1.6 | The budget documentation should report the fiscal position of sub-national governments and the finances of public corporations | BO | NO |
| 3.1.7 | The government should publish a periodic report on long-term public finances | **O** | **PO** |
| **3.2** | **Fiscal information should be presented in a way that facilitates policy analysis and promotes accountability** | | |
| 3.2.1 | A clear and simple summary guide to the budget should be widely distributed at the time of the annual budget | O | O |
| 3.2.2 | Fiscal data should be reported on a gross basis, distinguishing revenue, expenditure, and financing, with proper expenditure classification | O | PO |
| 3.2.3 | The overall balance and gross debt of the general government, or their accrual equivalents, should be standard summary indicators of the government's fiscal position | O | NO |
| 3.2.4 | Results achieved relative to the objectives of major budget programs should be presented to the legislature annually | O | PO |
| **3.3** | **Timely publication of fiscal information** | | |
| 3.3.1 | The timely publication of fiscal information should be a legal obligation of government | O | O |
| 3.3.2 | Advance release calendars for fiscal information should be announced and adhered to | O | PO |
| **IV.** | **Assurances of Integrity** | | |
| **4.1** | **Fiscal data should meet accepted data quality standards** | | |
| 4.1.1 | Budget forecasts and updates should reflect recent revenue and expenditure trends, underlying macroeconomic developments, and well-defined policy commitments | O | BO |
| 4.1.2 | The annual budget and final accounts should indicate the accounting basis used in the compilation and presentation of data | BO | PO |
| 4.1.3 | Data should be internally consistent and reconciled with relevant data from other sources. Major revisions to be explained | BO | PO |
| **4.2** | **Fiscal activities should be subject to effective internal oversight and safeguards** | | |
| 4.2.1 | Ethical standards of behavior for public servants should be clear and well-publicised | O | O |
| 4.2.2 | Public sector employment procedures and conditions should be documented and accessible to interested parties | O | O |
| 4.2.3 | Procurement regulations, meeting international standards, should be accessible and observed in practice | O | PO |
| 4.2.4 | Purchases and sales of public assets should be undertaken in an open manner, and major transactions should be separately identified | O | O |
| 4.2.5 | Government activities and finances should be internally audited and audit procedures should be open to review | O | O |
| 4.2.6 | The national revenue administration should be legally protected from political direction, and report regularly to the public on its activities | O | O |
| **4.3** | **Fiscal information should be externally scrutinised** | | |
| 4.3.1 | Public finances and policies should be subject to scrutiny by a national audit body | O | O |
| 4.3.2 | The national audit body to submit all reports, including its annual report, to the legislature and publish them | O | O |

| | | | |
|---|---|---|---|
| 4.3.3 | Independent experts to assess fiscal forecasts, the macroeconomic forecasts on which they are based, and their underlying assumptions | PO | PO |
| 4.3.4 | A national statistical body should be provided with the institutional independence to verify the quality of fiscal data | O | O |

*Memo Items*

| | Centre | | | | States | | | |
|---|---|---|---|---|---|---|---|---|
| Pillar | I | II | III | IV | I | II | III | IV |
| O | 9 | 7 | 10 | 10 | 6 | 4 | 4 | 8 |
| BO | – | 1 | 1 | 2 | 1 | 4 | – | 1 |
| PO | 1 | 1 | 2 | 1 | 3 | 1 | 7 | 4 |
| NO | – | – | – | – | – | – | 2 | – |

O – Observed; BO – Broadly Observed; PO – Partly Observed; NO – Not Observed;

The issues and recommendations by the Panel are broadly endorsed by the CFSA. The CFSA would, however, wish to present its views along with its own perceptions under certain key broad categories, such as inter-governmental relationships, taxation and expenditure, public debt and fiscal deficit, budget heads and accounting, and fiscal monitoring and reporting. The analysis of issues gives rise to recommendations for better budget preparation, monitoring and reporting of appropriate fiscal parameters at the levels of the Centre, state or local bodies or in the aggregate to capture the overall fiscal implications for and impact on the economy. The CFSA also addresses some overlapping recommendations by other Panels appropriately.

**6.4.31 Inter-governmental Relationships**

While the Constitution clearly demarcates functions between the Centre and States and areas where they hold concurrent responsibility, the Panel has observed that in practice, there are overlapping functions in important spheres, like health and agriculture, that have led to deterioration in the quality of governance, hampering timely responses to external shocks, and negates the purpose of defining separate spheres of responsibility. The CFSA endorses the view that functional overlap needs to be minimised or properly institutionalised, so that the roles of the Central and State Governments are clearly defined in practice and accountability is appropriately established.

The CFSA clarifies that the intention is not to redefine the constitutional provisions but to restore the provisions without distorting the functional demarcation. The peer reviewer, Mr. Vito Tanzi, has also acknowledged that clear demarcation of functional responsibilities between the Centre and the

States may not be possible as this is a constitutional issue and will be difficult to deal with outside a constitutional reform, which is a difficult enterprise.

To enhance the transparency of Finance Commission awards, the revenue-sharing calculations must be placed on the website.

At present, there is no independent institutional set-up to look into the implementation of the Finance Commission's recommendations. A clear channel needs to be established as part of the implementation process. To enhance the transparency of Finance Commission awards, the revenue-sharing calculations must be placed on the website. In this regard, the CFSA notes that the Expenditure Department, Ministry of Finance monitors devolution on the basis of the Finance Commission's recommendations.

While States are required to establish State Finance Commissions (SFCs) every five years to examine the transfer and devolution of resources from States to local bodies, the SFCs are not regularly appointed by the States. The CFSA endorses the view that all States should set up SFCs, ensure timely submission of Reports and report compliance with the rationale for rejecting any of the recommendations.

Many times, cover for losses by state PSUs is extended through equity contributions from the capital account, instead of subsidies through the revenue account. Such non-transparent transactions need to be curbed.

A common reporting framework for compensation and assignments to local bodies applicable to all States should be developed. Transfers of funds devolved to local levels should also be reported separately for rural and urban local bodies.

**6.4.32 Taxation and Expenditure**

On contractual arrangements, there are sometimes long delays by Governments in honouring payments to various entities (including inter-government) and individuals. Time-limits for payments should be honoured and there is a need to formally include such provisions as part of legal contracts along with suitable recourse mechanisms. Payments should be tracked down the line on an IT platform. The peer reviewer has noted that this is an area of concern as delays in payments could create a network of unsettled debts that can distort the entire accounting system, thus, sharply reducing transparency.

Tax assessees lack information on completed assessments and payment of refunds can be considerably delayed. All tax assessees must be informed of the initial assessments, accompanied by refunds/additional tax demand within a period of, say, six months. Timely settlement of appeals from tax-payers needs to be improved.

Public-private partnership (PPP) documents should include time-limits within which payments should be honoured.

State Governments should provide economic and functional classifications of expenditures annually.

State Governments, as a general rule, do not provide economic and functional classifications of expenditures annually in a systematic manner.

This is necessary, though a time lag of about six months after the budget may be permissible.

**6.4.33 Public Debt and Fiscal Deficit**

The Panel has observed discrepancies in the reporting of liabilities and deficit at various levels and there is scope to improve transparent fiscal reporting on these matters. The combined fiscal position of the Centre and State Governments as compiled by the Reserve Bank is being published in the Reserve Bank Bulletin, as also the Economic Survey and Public Finance Statistics issued by the Central Government. However, the overall public sector borrowing requirement (PSBR) is not reported in aggregate quantified form in the public domain. The CFSA recommends that Governments must make efforts to provide this data, even if borrowings by public sector undertakings is not in a narrow sense reportable as part of budgetary accounts of core governments.

State Governments do provide information on outstanding liabilities. But, contingent liabilities as a part of budget documents are not uniformly reported. The State Governments should provide these details in a uniform manner.

Data relating to debt should provide a break-down by instruments, maturity pattern and repayments falling due.

The liabilities of the State Governments reported in their respective budgets are at variance with the data reported in the central budget. The data on securities issued to NSSF in the state budgets do not match the central budget. The market borrowings reported in the state budgets also do not match the Reserve Bank's records. Further, data on outstanding loans from the Centre to the State Governments as per the Union Finance Accounts, Report of Comptroller and Auditor General (CAG) of India on Combined Finance and Revenue Accounts of the Union and State Governments in India and the Union Budget differ.

The CFSA felt that while it would be difficult to resolve completely such differences, the actual accounting figures cannot, in principle, differ. The CFSA endorses the Panel recommendation that a Working Group needs to be set up to sort out such discrepancies in fiscal data reported. However, the CFSA is of the view that the Working Group should first analyse the reasons for such discrepancy, which could be related to aspects such as consistency in definition, approach or time lag.

*Transparency in Fiscal Deficit: Inclusion of Securities issued in lieu of Subsidies*

While conceptually the net borrowing requirement of the Government during a fiscal year should match increase in debt stock during the same period, a widening discrepancy between the two has been observed in respect of the Central Government since 1999-2000. An analysis carried out by the research department of the Reserve Bank has attributed this largely to the issue of securities in lieu of subsidies to oil companies, Food Corporation of India (FCI) and fertiliser companies. As per the cash accounting system, since there is no immediate cash outgo from the Government, these additional securities issued do not form part of the government's Gross Fiscal Deficit (GFD).

Fiscal transparency would, however, require that these items, which are recognised as revenue expenditure and accounted for as much as 0.4 to 1.0 per cent of GDP between 2004-05 and 2007-08, should also be reflected in the revenue deficit and fiscal deficit at the time of issuance of these securities. In any scenario of increasing oil, food and fertiliser prices, since such securities are likely to show further increases, the CFSA fully endorses the Panel's recommendation that the budgetary documents should show 'augmented fiscal deficit' as a separate measure, accounting for issuance of such securities in lieu of subsidies. The CFSA also notes that the Thirteenth Finance Commission has been requested *inter alia* to address this issue specifically.

**6.4.34 Budget Heads and Accounting Issues**

The budget documents do not cover the actual audited expenditure statement of the Government. The audited accounts of expenditure are provided in the Finance Accounts which come out with a lag of about 6 to 9 months. The Advisory Panel on Financial Regulation and Supervision has recommended in this regard that both the Central and State Governments should consider reducing this time lag and also has suggested increasing the frequency of financial disclosures. The peer reviewer, Mr. Vito Tanzi, has also emphasised the need to develop better classification of expenditures as this is central to fiscal policy.

Under the present system, detailed scheme-wise information on government-funded schemes is available for the year-1 in the Detailed Demands for Grants of each Ministry/Department, which are also presented to Parliament, along with Revised Estimates for the current year and Budget Estimates for the year+1. The CFSA agrees with the Panel that expenditure on all government-funded schemes with a description of what they propose to achieve should be available on a yearly basis with progressive actual expenditure on each scheme. Currently, these details are available in the Annual Reports/Outcome Budgets of separate Ministries to which the schemes pertain. However, comparable time-series information should also be made available for the preceding years, so that monitoring of actual yearly expenditure on these schemes is not difficult.

There has been an undesirable widening of the gap between the net borrowing requirements of the Government and the increase in debt stock.

FRBM Acts in India typically configure fiscal targets in two distinct categories: the revenue deficit measures the excess of current expenditure over current revenue, and the gross fiscal deficit (GFD) measures the excess of total expenditure over non-debt receipts (equal to current revenue in the absence of privatisation receipts). The distinction between the two carries macroeconomic significance, but can get corrupted if there are expenditures which bundle the two types of expenditure and get assigned uniquely to one or the other category.

Therefore, some reclassification of bundled expenditure might be essential to maintain the usefulness of the revenue deficit as a targetable indicator, independent of the fiscal deficit. In this regard, the peer reviewer, Mr. Vito Tanzi, has commented that the relevant fiscal target should be the GFD and not the revenue deficit, as current expenditure can be highly productive in some cases. Though there is a need to measure capital spending and distinguish it from current spending, from the point of view of measurement of fiscal deficit to determine fiscal policy for macroeconomic purposes, GFD is clearly the preferred measure**.**

The purpose of budgetary heads and sub-heads is to categorise public expenditure such that the composition of public expenditure becomes transparent. The budgetary structure in India has evolved by accretion over time and does not at present adequately convey the functional content of each budget head category. Several problems were identified by the Panel in a detailed manner which included duplication; differentiation by type of flow; basis of categorisation; budget heads and functions; rural/urban differentiation; State-local basic grants; Centrally-funded schemes; demand structure; and gross and net capital flows.

The CFSA recommends the appointment of a Working Group to restructure and rationalise the budget head structure for reporting expenditures. The revised budget head structure should be made binding on all Governments. The CFSA, however, suggests that these issues must first be referred to the CAG before setting up the Working Group.

The accounting system should enable a transparent separation of urban from rural in the fund flow to local bodies.

*Move towards Accrual-based Accounting/Budgeting*

The Advisory Panel on Financial Stability Assessment and Stress Testing has emphasised that fuller capital account convertibility would eventually imply better fiscal transparency standards – tighter and more elaborate disclosures and accounting norms in line with international best practices. Governments the world over mainly follow cash-based accounting, budgeting

and reporting, but in recent years there is a strong tendency on the part of institutions, such as the IMF, the OECD and, in India, the Twelfth Finance Commission, of urging Governments both at the Centre and States to move over to accrual-based accounting. The recommendation of the Twelfth Finance Commission for moving over from cash-based accounting towards accrual-based accounting was, in principle, accepted by the Government. The Government Accounting Standard Advisory Board (GASAB), a body in the office of the Comptroller & Auditor General of Accounts, was entrusted with drawing up a roadmap and operational framework for the introduction of accrual accounting in the Government. While addressing this issue, the Advisory Panel has brought out the pros and cons of accrual-based accounting and also has noted the current efforts of the GASAB in suggesting a roadmap for transition to accrual accounting.

Government accounting in India follows cash-based accounting.The roadmap and operational framework have been finalised by GASAB, including an indicative timeframe of 10 to 12 years for migration to accrual accounting. CAG, CGA and other accounting organisations are, at present, conducting pilot studies, the outcome of which is awaited. In addition to this, GASAB is also preparing to prescribe accrual-based Accounting Standards for certain key areas and some exposure drafts are being considered by the Board. Twenty-one State Governments have expressed their agreement to migrate to accrual-based accounting. Following some pilot studies, the GASAB took a landmark decision in July 2008 to develop accrual-based accounting standards for the Government. The standards will be proposed by GASAB to be issued as Indian Government Financial Reporting Standards (IGFRS) through notifications by the Central Government. Upon such notification, these standards will be applicable to the Central and State Governments in preparation of accounts under accrual-based accounting. These standards are envisaged to facilitate ongoing pilot studies for migration to accrual-based accounting in the Central and State Governments. These standards will initially be issued as recommendatory to facilitate transition to accrual-based accounting.

The peer reviewer, Mr. Vito Tanzi, has also endorsed the Panel's recommendation that a gradual shift towards accrual-based accounting could be considered as this is in line with the present thinking of the IMF and OECD. He has acknowledged that a move towards accrual-based accounting requires skills not easily available and information that is not easily obtainable.

The Twelfth Finance Commission wants Governments to move towards accrual-based accounting.

In the above context, the CFSA feels that it is necessary to discern clearly the advantages and disadvantages of both cash-based accounting and accrual-based accounting and, in practice, how far accrual-based accounting is being followed in other countries. In the present system of cash-based accounting, transactions are recognised only when the cash payment or receipt is actually made during a reporting period. The advantages of this system are that it is

relatively simple to follow, it complies with the present legislative and budget procedure and the main focus is cash management.

A cash accounting system, however, also creates distortions in understanding the inherent resource flows of the Government, inasmuch as it does not account for expenditure already incurred but payments not made, and of revenue earned but cash not received. Second, the account is incomplete or partial as far as assets and liabilities are concerned; in particular, it excludes current and pension liabilities. As a result, cash-based accounting does not provide a true or fair view of government accounts. Accrual-based accounting provides information both on cash and non-cash transactions, as revenue and expenses are accounted in a comprehensive manner. It will account for tax assessed but not received, as also bills raised but not paid. Similarly, it would account for liabilities accrued but not paid. Assets and liabilities, both short-term and long-term, are reflected adequately, including pension liabilities and depreciation cost.

The information and skill-sets required for accrual-based accounting are enormous. As a result, most countries still follow cash-based accounting. Of the 64 countries covered by the SDDS, only seven fully follow the accrual-based accounting system: Austria, Belgium, Denmark, Iceland, Argentina, Greece and Poland, most of which are small economies. Cash-based accounting is followed by 50 per cent of the countries, of which Canada and Germany are the developed countries. The remaining 19 countries follow a mixed accounting system; in this category, there are emerging market countries, such as Brazil, Egypt, Israel, Malaysia, Peru and Singapore.

A survey of budget practices and procedures by the OECD shows that of the 30 countries, 15 countries fully follow cash-based accounting and only five countries fully follow accrual-based accounting. While three countries follow both systems, six countries follow a mixed system.

Accrual-based accounting for financial reports does not necessarily need accrual-based budgeting.

The CFSA notes that accrual-based accounting for financial reports does not necessarily need accrual-based budgeting. While the former is subject to audit, the latter is not. While financial reporting can be on accrual-based accounting, budgeting can still be on a cash basis. The OECD survey shows that of the 30 countries, 11 countries report accrual-based financial statements and another 11 report cash-based financial statements. Of the remaining eight countries, two follow both systems and six follow a mixed system.

While, in principle, the CFSA agrees that accrual-based accounting to a great extent removes shortcomings on account of limitations of cash-based accounting distorting the fiscal reporting, at the same time it recognises that switching over to accrual-based accounting is not a simple or easy task and requires huge investments in skill development. There are also serious problems of tackling information that may not be easily available. Above all, government accounts cannot be treated on par with private accounting, which follows commercial principles. For Governments, it is an analytical tool for decision-making and not an end in itself.

The system, therefore, needs to be adapted to the requirements of social policy and commitments and the nature of public goods provided by the Government. The main advantage of accrual-based accounting lies in the fact that it provides more comprehensive, accurate and reliable financial information and, hence, promotes better transparency. To be effective, the new system would presuppose the skills of accountants, the quality of audit and reporting processes and also the capacity of stakeholders and users of fiscal information. While acknowledging these, Mr. Vito Tanzi has rightly observed that this is the reason why relatively few countries have made a full conversion to accrual-based accounting. He adds that this is a desirable course of action but is to be followed with particular care and after adequate preparation. The CFSA fully concurs with this view.

The CFSA, therefore, recommends that there should not be any hasty move towards accrual-based accounting and it should be treated with extraordinary care and caution and attempted in phases only after preparing a strong ground in terms of skills and awareness at all levels. The CFSA also endorses the view of the Advisory Panel that such a move has to be phased in such a manner that there is no confusion or disruption of time-series on important fiscal indicators. There has to be a well-planned transition, with officials at Central and State-levels who are well-trained in the new accounting system. The CFSA hastens to add that this should not preclude the Governments from removing serious distortions caused by cash-based fiscal reporting on account of factors such as deferment of payment of subsidies through issue of bonds.

**6.4.35 Fiscal Monitoring and Reporting**

The CFSA notes that with fiscal responsibility legislations in place, the monitoring and reporting of fiscal indicators has enormously improved. The Central Government sets forth a three-year rolling target for prescribed fiscal indicators with broad specification of underlying assumptions. These are set out in the Medium-term Fiscal Policy Statement laid down with the Union Budget. These could, however, be further enhanced by providing sensitivity analysis for fiscal projections with respect to the underlying parameters assumed. Similarly, FRLs in general make State Governments more accountable and transparent, with provisions for quarterly/half-yearly fiscal reviews and setting up of an independent agency to review the compliance

A shift to accrual-based accounting must be undertaken with particular care and after adequate preparation.

provisions of the Act. However, there is need for sensitivity analysis of fiscal forecasts and quantification of fiscal risks.

The Reserve Bank has been publishing data on the combined government finances of the Centre and State Governments as per the IMF's SDDS. While the Central Government reports its finances for the IMF publication, *Government Finance Statistics* (GFS), there is no reporting of State Government or combined government finances in the GFS. The CFSA recommends that progress in this regard should be made in the medium-term, along with the phased introduction of accrual accounting. The CFSA endorses the view of the Advisory Panel that the Reserve Bank should continue to compile and publish, as per the present SDDS requirements, the general government public finance statistics within six months of the end of the reference year.

A common feature of budget estimates for Revenue Deficit and Fiscal Deficit of the State Governments is that they may be seriously out of line with the monotonic reduction implicit in their respective Acts. Although the actuals show compliance with the legislated targets, the issue of fiscal marksmanship is important. In this context, the CFSA agrees with the Panel that fiscal marksmanship at the state-level needs strengthening, so that budget expenditure estimates do not exceed the known feasible limits.

Several other issues have also been raised regarding the dissemination of fiscal data, monitoring and reporting.

The public capital outlay in any state is an aggregate of State Government-funded outlays and outlays funded directly by the Central Government which are not all routed through the State Exchequer, and can either be spent directly by line outposts of the Centre, or through sub-State-level agencies, or through local governments. Though the office of the CAG compiles the combined Finance Accounts for the Central Governments and State Governments, there is a significant time lag in the availability of information in view of the time lag in finalisation of State accounts. There is no ready source of data on this aggregate, which makes the public capital outlay in a State impossible to quantify. The CFSA recommends that the Working Group on budget heads should address this issue specifically.

Fiscal marksmanship at the state-level needs strengthening. Expenditure estimates should not exceed feasible limits.

Disinvestment receipts are officially provided only at the Central level; there are no source records of disinvestment receipts in aggregate across States. The CFSA strongly recommends that this be resolved.

Local bodies' own revenues and expenditures are becoming sufficiently important that there should be a systematic provision for collection of data on these. The only sources so far have been the Reports of the National Finance Commissions, starting with the Eleventh Finance Commission, but the revenue data reported there seem to be inflated, from the evidence of sample survey-based studies. The CFSA recommends that this needs to be streamlined. The Working Group for resolving discrepancies in fiscal reporting may address this issue as well.

### 6.4.4 Summary

The CFSA notes that the enactment of the FRBM Act in 2003 and the FRLs by the States have led to significant progress by the Central and State Governments in enhancing transparency in fiscal reporting and monitoring. However, the assessment has brought out some areas of concern and the recommendations made by the CFSA pertain to the following:

A Working Group needs to be set up to sort out the discrepancies in fiscal data reported by various data disseminating agencies, particularly borrowings by PSUs and contingent liabilities of State Governments.

Central and State Governments should reduce the time lag in publishing the actual audited expenditure statement and increase the frequency of financial disclosures.

Expenditure on all government-funded schemes with descriptions of what they propose to achieve should be available on a yearly basis, with progressive actual expenditure on each scheme.

A Working Group to restructure and rationalise the budget head structure for reporting expenditures should be appointed after first referring to the CAG.

A move towards accrual-based accounting should be attempted only in phases after ascertaining the benefits and preparing a strong ground in terms of skills and awareness at all levels. However, this should not preclude Governments from removing serious distortions caused by cash-based fiscal reporting.

To reduce delays by Governments in honouring payments to various entities and individuals, there is a need to formally include such provisions as part of legal contracts along with suitable recourse mechanisms.

Public-private partnership (PPP) documents should include time limits within which payments should be honoured.

Fiscal reporting and monitoring at the Centre and state-levels could be further enhanced by providing sensitivity analysis for fiscal projections, with respect to the underlying parameters assumed and quantification of fiscal risks.

The mode of calculation of fiscal deficit fails to capture the impact of off-budget items or provide such figures separately. The budgetary fiscal deficit needs to be accompanied by an augmented fiscal deficit to capture off-budget items, such as oil bonds, FCI bonds and fertiliser subsidies.

The overlapping functions of the Central and State Governments need to be minimised or properly institutionalised, so that the roles of the Central and State Governments are clearly defined in practice and accountability is appropriately established.

The States should establish State Finance Commissions (SFCs) for devolution of resources from States to local bodies, and ensure timely submission of Reports, and report compliance along with the rationale for rejecting any of the recommendations.

State Governments should provide economic and functional classifications of expenditures annually in a systematic manner. Disinvestment receipts in aggregate across States should be provided.

There is no ready source of data on public capital outlay in a state as there is significant time lag in the availability of combined finance accounts for the Union and State Governments in view of the time lag in finalisation of State accounts. The Working Group on budget heads should address this issue specifically.

## 6.5 Data Dissemination Standards

### 6.5.1 Benchmark

The Special Data Dissemination Standards (SDDS) by the IMF guides members in disseminating economic and financial data to the public (Box 6.5). While subscription to the standards is voluntary, observance of the standards is mandatory for subscribing members. At present, only 64 member countries participate in the SDDS and India has been one of the initial subscriber members since December 27, 1996 and has started posting its metadata from October 30, 1997. India disseminates data on various macro-economic parameters on the National Summary Data Page in order to meet the SDDS requirement. The IMF has also prescribed a Data Quality Assessment Framework (DQAF) that is used for comprehensive assessment of countries' data quality. It covers institutional environment, statistical processes, and characteristics of the statistical products. The DQAF comprises a generic framework and a set of dataset-specific frameworks. The DQAF comprises five dimensions: pre-requisites of quality, assurances of integrity,

### Box 6.5: IMF's Special Data Dissemination Standards

The IMF's Special Data Dissemination Standards (SDDS)-2007 identifies four dimensions of data dissemination:

Data: Coverage, Periodicity (frequency), and Timeliness;

Access by the public;

Integrity of the disseminated data; and

Quality of the disseminated data.

For each of these dimensions, the SDDS prescribes best practices that can be observed or monitored by the users of statistics. These practices are referred to as 'monitorable elements'. Key dimensions and monitorable elements of the SDDS are:

Data: Coverage, Periodicity, and Timeliness**:** Comprehensive economic and financial data, disseminated on a timely basis, are essential to the transparency of macroeconomic performance and policy. Countries subscribing to the SDDS are to:

- Disseminate the prescribed categories of data with the specified periodicity and timeliness.

Access by the public**:** Dissemination of official statistics is an essential feature of statistics as a public good. The SDDS calls for providing the public, including market participants, ready and equal access to the data. Countries subscribing to the SDDS are to:

- Disseminate advance release calendars for the data; and
- Release the data to all interested parties simultaneously.

Integrity: To fulfill the purpose of providing the public with information, official statistics must have the confidence of their users. In turn, confidence in the statistics ultimately becomes a matter of confidence in the objectivity and professionalism of the agency producing the statistics. Transparency of its practices and procedures is a key factor in creating this confidence. The SDDS requires subscribing countries to:

- Disseminate the terms and conditions under which official statistics are produced, including those relating to the confidentiality of individually identifiable information
- Identify internal government access to data before release
- Identify ministerial commentary on the occasion of statistical releases
- Provide information about revision and advance notice of major changes in methodology.

Quality**:** A set of standards that deals with the coverage, periodicity, and timeliness of data must also address the quality of statistics. Although quality is difficult to judge, monitorable proxies, designed to focus on information the user needs to judge quality, can be useful. The SDDS requires subscribing countries to:

- Disseminate documentation on methodology and sources used in preparing statistics
- Disseminate component detail, reconciliations with related data, and statistical frameworks that support statistical cross-checks and provide assurance of reasonableness.

methodological soundness, accuracy and reliability, serviceability, and accessibility.

### 6.5.2 Earlier Assessments

The Advisory Group on SDDS (2001) assessed India's record of SDDS compliance based on original specifications for the coverage, periodicity and timeliness of data as also for the Advance Release Calendar. The Group

identified four grey areas in India's compliance to SDDS: (i) labour market data on employment/unemployment and wages; (ii) general government or public sector operations; (iii) international investment position; and (iv) data templates on international reserves and foreign currency liquidity.

The Group noted that India has chosen the flexibility option available under SDDS for labour market data, recognising the complex structural features of the Indian economy, large agricultural sector and sizeable unorganised employment in the non-farm sector. As regards general government and public sector operations, the Group recommended that the Central Statistical Organisation (CSO)/Central Government/State Governments and the Reserve Bank should co-ordinate data gathering/ compiling activities and dissemination of data pertaining to general government (public sector) operations. The Group also recommended dissemination of information on the composition of foreign exchange and maturity break-up of forward liabilities and suggested dissemination of forward-looking indicators in certain sectors, *viz.*, surveys of business expectations and summary methodologies for all data categories under SDDS.

An assessment of six macroeconomic data-sets under the DQAF was conducted by the IMF team under Report on Observance of Standards and Codes (ROSC), 2004, *viz.*, (i) national accounts, (ii) consumer price index, (iii) wholesale price index, (iv) government finance statistics, (v) monetary statistics, and (vi) balance of payments statistics.

The Report concluded that India is in observance of the SDDS. It meets the specifications for coverage, periodicity, and timeliness in all data categories except for i) the timeliness of data on general government operations, for which it takes the flexibility option to which it is entitled and ii) the periodicity and timeliness for labour market data, for which it takes the 'as relevant' flexibility options. The Report also assessed data quality issues and made certain recommendations.

**6.5.3 National Statistical Commission**[150]

A Commission set up by the Government in January 2000 under the Chairmanship of Dr. C. Rangarajan reviewed the statistical system and the entire gamut of official statistics in the country. The Commission, which submitted its Report in 2001, examined deficiencies in the statistical systems in India in terms of their timelines, reliability and adequacy and

[150] Source: National Statistical Commission website.

recommended measures to revamp the statistical systems to generate timely and reliable statistics for the purpose of policy and planning. The major recommendations of the Commission included the establishment of a permanent National Commission on Statistics to serve as a nodal and empowered body for all core statistical activities of the country, to evolve, monitor and enforce statistical priorities and standards and to ensure statistical co-ordination among the different agencies involved. On national accounts statistics, the Commission recommended that it should contain not merely national-level accounts but also regional accounts at the state-level. On price indices, the Commission recommended frequent revision in the base year of the WPI, development of an all-India CPI for urban and rural areas and a separate price index for the services sector. On financial and external sector statistics, the Commission suggested strengthening the process of collection, compilation and dissemination of data by the respective data dissemination agencies. Some of these recommendations have been implemented, including the setting up of the National Statistical Commission (NSC) and the institution of the office of a Chief Statistician of India.

The main functions of the Commission include the following: to identify the core statistics, which are of national importance and critical to the development of the economy; to evolve national policies and priorities relating to the statistical system; to evolve standard statistical concepts, definitions, classifications and methodologies in different areas in statistics and lay down national quality standards on core statistics; to evolve national strategies for the collection, tabulation and dissemination of core statistics, including the release calendar for various datasets; to exercise statistical co-ordination between Ministries, Departments and other agencies of the Central Government; to exercise statistical audit over the statistical activities to ensure quality and integrity of the statistical products; and to monitor and review the functioning of the statistical system in light of the laid-down policies, standards and methodologies and recommend measures for enhanced performance.

### 6.5.4 Assessment and Recommendations by the Advisory Panel on Transparency Standards

Building upon the earlier assessments, the Panel has concluded that India is largely compliant with the requirements of SDDS and exceeds the disclosure requirements in several areas. The present assessment, therefore, essentially articulates areas where India can deliver a performance that is better than expectations and relies mainly on the DQAF. Even in the DQAF, the emphasis has been on those issues which are more relevant in the Indian context. A summary of observance of the DQAF is provided in Table 6.4.

India is largely compliant with the requirements of SDDS and exceeds the disclosure requirements in several areas.

One key issue addressed by the Panel relates to the institutional arrangements for data compilation. The Panel has also addressed critical issues relating to the methodology and techniques used in data compilation. While historically data collection has been attempted through the concerned

**Table 6.4: Data Quality Assessment Framework – Summary of Results**

| Element | National Accounts | WPI | CPI-IW | Government Finance Statistics | Monetary Statistics | Balance of Payments |
|---|---|---|---|---|---|---|
| **0. Pre-requisites of quality** | | | | | | |
| 0.1 Legal & institutional environment | LO | LO | O | LNO | O | LO |
| 0.2 Resources | LO | O | O | LO | O | O |
| 0.3 Relevance | LO | O | O | LO | O | O |
| 0.4 Other quality management | O | O | O | O | O | O |
| **1. Integrity** | | | | | | |
| 1.1 Professionalism | O | O | O | O | O | O |
| 1.2 Transparency | O | LO | O | LO | O | O |
| 1.3 Ethical standards | O | O | O | O | O | O |
| **2. Methodological Soundness** | | | | | | |
| 2.1 Concepts & definitions | LO | LO | O | LNO | O | LO |
| 2.2 Scope | LO | O | LNO | LO | O | O |
| 2.3 Classification/Sectorisation | LO | O | O | O | O | O |
| 2.4 Basis for recording | LO | O | O | O | O | O |
| **3. Accuracy and Reliability** | | | | | | |
| 3.1 Source data | LNO | LO | LO | O | O | O |
| 3.2 Assessment of source data | LNO | LNO | O | O | O | O |
| 3.3 Statistical techniques | LNO | O | LO | O | O | O |
| 3.4 Assessment and validation of intermediate data and statistical outputs | O | O | O | O | O | O |
| 3.5 Revision studies | LO | O | O | LO | O | LO |
| **4. Serviceability** | | | | | | |
| 4.1 Timeliness and periodicity | O | O | O | LO | O | O |
| 4.2 Consistency | LO | O | O | O | O | O |
| 4.3 Revision policy and practice | LO | O | LO | LO | O | O |
| **5. Accessibility** | | | | | | |
| 5.1 Data accessibility | LO | O | O | LO | O | O |
| 5.2 Metadata accessibility | LO | LO | O | LNO | O | O |
| 5.3 Assistance to users | LO | LO | O | LO | O | O |

O – Observed; LO – Largely Observed; LNO – Largely Not Observed; NO – Not Observed.

administrative machinery, with reforms, liberalisation and decontrol these mechanisms have been weakened. Hence, there is a general thrust by the Panel to rely less on such sources and more on strengthening the professional statistical wings to assume greater responsibility for compilation, analysis and dissemination.

Second, wherever multiple agencies are involved, for example, in respect of labour/employment statistics, concerted efforts should be made to

centralise these efforts with professional statistical wings so that India will not have to seek flexibility options under the SDDS from the IMF.

Third, in the fiscal sector, migration to an internationally-accepted data framework like the *Government Finance Statistics Manual* (GFSM), 2001 would require overhauling the accounting system besides sharing responsibilities between the Government and the Reserve Bank.

Fourth, the Panel has emphasised the need to introduce new data on business and consumer expectations by way of strengthening dissemination of forward-looking indicators.

The peer review of the Report on SDDS was done by Mr. Neil Patterson, former Director, Statistics Department, IMF who complimented the panel on the quality of the assessments and the recommendations. He noted that the Panel's Report goes beyond the assessment of India's adherence to the IMF's Standard by assessing the quality of the selected SDDS data-sets against the IMF's DQAF.

The CFSA notes that much of the statistical data was obtained by government agencies through powers and authority granted to the administrative machinery by various legislations. With the reform process initiated since the early 1990s, data collection for administrative requirements has weakened and data submission is mainly voluntary. There has also been significant expansion in the role of the services sector in the economy, whose data is not adequately captured at present. There is, therefore, a need for a collaborative arrangement between the Centre and State Governments in generating accurate and reliable industrial data. The quality of the agricultural data has also deteriorated with the weakening of the land revenue system and the consequent unreliability of the estimates of land use. There is also a need to supplement the national statistics with state-level statistics which would allow comparable analysis of economic problems and performance at the state-level. There is also a need for co-ordination between the CSO and the central ministries involved in data collection, as also between the state statistical bureaus and the ministries in the States[151].

The CFSA is in broad agreement with the assessment and recommendations of the Advisory Panel with regard to various components of data segments in the real sector, prices, fiscal, financial and external sectors. Some of the issues relating to fiscal data reporting are covered by the CFSA as part of the section on Fiscal Transparency, as there were some overlapping recommendations and the CFSA had a different point of view on the issue of accrual accounting. On other issues, the CFSA attempts to consolidate and present the actions recommended by the Advisory Panel on the part of three major agencies, *viz.*, the CSO, the Central Government and the Reserve Bank.

There is need for a collaborative arrangement between the Centre and the States to generate accurate and reliable industrial data.

[151] Ref: Prime Minster's address at the Conference of States and Union Territories on management of statistics, September 9, 2008.

**6.5.41 Central Statistical Organisation (CSO)**

The Central Statistical Organisation (CSO) is responsible for co-ordinating statistical activities in the country, and evolving and maintaining statistical standards. Two major areas come under the purview of the CSO, *viz.*, National Accounts and Index of Industrial Production (IIP). The CSO is the nodal agency for compilation of national accounts statistics. A large number of independent ministries, departments and local agencies provide the CSO with the requisite information. With liberalisation and reforms, several of the traditional links that compiled and provided statistics to the CSO have deteriorated. The Panel notes that the legal and institutional environment of the national accounts statistics, as brought out by the National Statistical Commission, continue to remain weak. Generally, the accuracy and reliability of the expenditure side of the GDP is much lower than that of the production side. Private final consumption expenditure is derived and not estimated. There is a need to substantially improve the accuracy of the expenditure-side statistics of the national accounts. The CFSA believes that the CSO needs to be strengthened to ensure that the generation of the national accounts is well-supported by the legal and institutional environment it merits.

The Panel observes that traditional institutional users of CSO data are often intimated of changes in methodology; however, such information is not easily available in the public domain. The CFSA is of the view that it would be useful if the CSO made all material pertaining to changes in methodology automatically available on its website.

There are also several gaps in the statistical techniques used by the CSO. In general, the CSO's statistical techniques need greater independent review so that the CSO can make appropriate changes in its techniques. Advance notice may also be given for major changes in methodology, source data and statistical techniques. The CSO follows a well-set system of providing provisional and revised data estimates. The CFSA concurs that the CSO may study and analyse its revisions and make such studies public to help users understand the revisions better.

The CSO needs to be strengthened so that it can do a better job.

The CSO is also the nodal agency for compilation of the Index of IIP. It compiles the data supplied by a multitude of sources, the largest source being the Department of Industrial Policy and Promotion (DIPP), which accounts for over half of the items included in the index and more than half of the weight. As in the case of national accounts, with liberalisation (de-licensing in

particular), the institutional data collection machinery has suffered. For example, since the removal of the industrial licensing regime in the early 1990s, there is no longer any compulsion for firms to submit comprehensive data on a range of indicators essential to industrial statistics. The data submission is largely voluntary and, in the process, has weakened considerably.

The Panel has recommended strengthening the implementation of the existing arrangements and consolidating the source agencies that provide the source data. The CSO should assume direct responsibility in generating the IIP. It should create the frame, select the sample and collect the data directly from the units. Its reliance on the administrative machinery and on industry associations should be reduced. Further, when consolidating the source agencies, the CSO should reduce its reliance on the administrative machinery and industry associations, and strengthen its own direct capabilities. The CSO can further improve the transparency of the IIP if it reveals the size (number) of units in the frame, the sample size and the monthly response rate for each item of the IIP.

The IIP needs to adjust its basket of commodities and the weights assigned to these more rapidly than it currently does. The IIP currently excludes construction, gas and water supply, but the United Nations Statistical Office recommends their inclusion in the IIP. It would be useful if the scope of the IIP was expanded to include these sectors. The publication of the response rate with each release would also enable users to anticipate changes in the estimates and appreciate the revisions when they occur. The CFSA supports these recommendations.

The Panel has made a far-reaching recommendation to improve the methodology in compiling IIP data, *i.e.*, a move towards a chain-linked index instead of a base-linked index. While the CFSA appreciates the merit in this view, given the fast-changing commodity sector profile due to modernisation and new technology, the full implications of such a change in terms of coverage, consistency and continuity in time-series must be examined by the Government before implementation.

**6.5.42 Central Government**

The two areas addressed here are data on the labour market and on prices; on fiscal data, issues pertaining to the Government are covered in the section on Fiscal Transparency. The Panel has observed that India's labour market databases are inadequate and fail to provide reliable information. Previous efforts have not adequately addressed the complexities of the Indian labour markets. Although multiple agencies are involved in measuring employment, unemployment and wages in India, there is no single comprehensive and reliable estimate of any of the three basic measures of labour markets – employment, unemployment and wages – on a regular basis with acceptable periodicity or timeliness.

The IIP needs to adjust its basket of commodities and weights more rapidly.

The Panel has recommended that the fragmented efforts in compiling statistics relating to the labour markets be consolidated under one institution that is adequately empowered to undertake this task comprehensively and effectively. The CSO, as the premier statistical agency of the country, is the most appropriate agency to undertake this responsibility with the help of the National Sample Survey Organisation (NSSO). It would be ideal if this new effort also conforms to the standards laid down in the DQAF.

The Panel has recommended that statistics be compiled by professional statistical agencies that deploy appropriate statistical methodologies rather than by the administrative arms of the Government through voluntary or statutory compliance of legislations.

As regards data on prices, India meets the requirements in terms of coverage, periodicity and timeliness for the price indicators for SDDS comprehensively. It disseminates to the public more detailed price change indices than required under the SDDS. The WPI is more transparent than CPI-IW, because it provides index numbers for individual items in the overall index[152]. However, the WPI provides only the index and not the price, limiting its utility. In the interest of increasing the transparency and application of the WPI, the CFSA endorses the recommendation that the WPI also reveal the prices underlying the creation of the indices.

The price indices are produced on an objective basis. Statistical techniques and decisions regarding dissemination are based on statistical and professional considerations. However, the choice of sources is based largely on operative convenience arising from using the administrative machinery. There is scope to improve this selection as, in several markets, sophisticated systems have been established to collect reliable price estimates of commodities. This is particularly true in light of the establishment of several commodity futures exchanges. The CFSA supports the recommendation that the efforts of the agencies in collecting prices to measure inflation also exploit these new sources.

The WPI should also reveal the prices underlying the creation of the indices.

The Labour Bureau's policies with respect to the generation of the CPI-IW is transparent. This is also the case with the Office of Economic Advisor in the generation of the WPI. However, the CFSA endorses the view that these agencies need to substantially improve on this count by revealing the number of respondents in the frame, the monthly response rates, the revision in the

[152] See also the CFSA's discussion on price index in Chapter 6, Section 6.1.2.

responses and the policies they follow with respect to revisions. This information may also be made public for a fair assessment of the credibility of the price indices. The recent developments in respect of price indices is given in Box 6.6.

The WPI suffers seriously from outdated weights. Its base year is as of 1993-94, *i.e.*, the weights reflect the situation nearly 14 years ago. The economy has undergone tremendous changes since then and the dated weights do a great disservice to users of the index. Infrequent updating of weights leads to the use of outdated weights in the indices; it also often excludes new products. As in the case of the IIP, the Panel has recommended a move towards a chain-linked index instead of a base-linked index. The CFSA reiterates its view, as in the case of IIP, that the full implications of this change should be examined by the Government before implementation.

**6.5.43 The Reserve Bank of India**

The issues addressed here pertain to forward-looking indicators and the external sector. The Reserve Bank's role also figures prominently in respect of fiscal data which is covered in the section on Fiscal Transparency. India does not provide any forward-looking indicators. The SDDS encourages (it does not prescribe) the dissemination of one or more forward-looking indicators. These include surveys of expectations, such as qualitative surveys of business managers' or consumers' expectations, or order book positions. It also includes combination indices like 'leading indicators' or business cycle indices. The Reserve Bank does conduct quarterly surveys on capacity utilisation and order-book positions. The CFSA endorses the Panel's view that these could be used to develop a full set of forward-looking indicators and disseminated.

**Box 6.6: Recent Developments in respect of Price Indices**

The Abhijit Sen Committee, formed in 2004, was given the task of updating the base of WPI to 2000-01 to match the Consumer Price Index (CPI) for Industrial Workers, which has a base year of 2001. The Committee has proposed the roll-out of a new price index to be called the Producers' Price Index (PPI) with a base year of 2004-05 that is extended to cover 2,000 products. The Committee has also recommended a changeover to a monthly index in the WPI in line with standard practice in other countries. Accordingly, the Government plans to release a revised WPI with 2004-05 as the base year from 2009. The proposed 2004-05 base series will have 1,224 commodities (against the 435 items in the present WPI series).The primary articles and fuel will have almost the same number of items as the present series, while there would be about 1,100 manufactured products in the proposed series. In each of these individual commodities, it is planned to obtain at least five price quotations. This is unlike the present WPI series where, of the total of 435 items, 214 items are represented by three or fewer quotations. The Government plans to obtain quotations for about 5,000 reporting firms online from the Office of the Economic Advisor in the Ministry of Commerce and Industry, on a monthly basis.

However, the Reserve Bank has suggested that the 65-year old practice of compiling the WPI on a weekly basis should continue.

The Reserve Bank should develop a set of leading indicators.

The Panel has observed that there is no formal law or arrangement assigning responsibility for the collection, processing and dissemination of data relating to balance of payments with the Reserve Bank. Most of the information obtained is a bye-product of reporting of foreign exchange transactions by Authorised Dealers. Thus, data collection is a function of the regulations in force and is vulnerable to possible reforms in future. Data collection may suffer, as it did in the case of the IIP and the WPI. The CFSA is of the view that the Reserve Bank could make arrangements for the data to be collected through a more professional and sustainable system.

The Reserve Bank conducts user surveys for the Reserve Bank Bulletin that contains the balance of payments data. In response to users' needs, the Reserve Bank has been improving its presentation structure by providing more disaggregated components of Balance of Payments, *e.g.*, break-up of miscellaneous services such as software services, business services, financial services and communication services. A formal Revisions Policy has been put in place since September 2004. There have not been any analyses or studies of revisions, though explanations of large revisions are provided at the time of their dissemination.

**6.5.5 Summary**

India is broadly compliant with the IMF's SDDS and exceeds the requirements under the code in several areas. The CFSA recommends strengthening the major official data collection agencies in the country, *viz.*, the CSO in the compilation of national accounts statistics and the IIP, the Central Government in the compilation of labour market data and price indices and the Government and the Reserve Bank in the compilation of balance of payments data and lead indicators.

With liberalisation and reforms, several traditional links that compiled and provided statistics to the CSO have deteriorated as data submission to the CSO is now largely on a voluntary basis. The accuracy and reliability of the expenditure side of the GDP is much lower than that of the production side in the computation of national accounts statistics. The CSO needs to be strengthened to ensure that the generation of the national accounts is well-supported by the legal and institutional environment it merits. The CSO should also reduce its reliance on administrative machinery and industry associations and strengthen its own direct capabilities. The CSO can further improve the transparency of the IIP if it reveals the size (number) of units in the frame, the sample size and the monthly response rate for each item of the

IIP. The IIP needs to adjust its basket of commodities and the weights assigned to these more quickly than it currently does.

Multiple agencies are involved in the measurement of employment, unemployment and wages in India. The fragmented efforts in compilation of statistics relating to the labour markets should be consolidated under one institution, ideally the CSO with the help of the NSSO.

The Labour Bureau and the Office of Economic Advisor in the Ministry of Commerce and Industry could enhance their transparency practices in generating the CPI and WPI, respectively, by revealing the number of respondents in the frame, the monthly response rates, the revision in the responses and the policies they follow with respect to revisions. This information may also be made public for a fair assessment of the credibility of the price indices. There is also an urgent need to update the weights and basket of goods used for the computation of the WPI. There is also scope for improving the data sources, particularly in view of the establishment of commodity exchanges.

There is no formal law or arrangement assigning responsibility for the collection, processing and dissemination of data relating to balance of payments with the Reserve Bank. Arrangements could be made by the Reserve Bank so that the data is collected through a more professional and sustainable system. The Reserve Bank could also develop a full set of forward-looking indicators, like surveys of expectations, and disseminate it.

## 6.6 Concluding Remarks

The recent turmoil in the financial markets has brought to the fore the importance of enhanced transparency and disclosure of information by market participants in order to ensure financial stability. The Advisory Panel on Transparency Standards has highlighted the efforts and the progress made by India in enhancing policy transparency and data dissemination. There are some areas where further transparency and disclosure can be achieved.

The main issues that have come out of the assessment of transparency in monetary policy pertain to the review of legislation with regard to the objectives of monetary policy, the issue of operational independence and accountability of the Reserve Bank and the separation of debt management and monetary management.

The CFSA felt that, at the current juncture, significant changes to the statutory basis for refining monetary policy objectives may not be required and the current statutory provisions are flexible and clear enough for the Reserve Bank to define policy objectives and implement monetary operations to fulfill its objectives. Any rigid framework, explicitly incorporated in legislation or mandated otherwise, would reduce this flexibility.

As regards operational independence and accountability, the Committee feels that as per convention, the Reserve Bank enjoys independence vis-à-vis the executive arm of the state. In practice, through conventions, agreements

and MoUs in specific areas, the Reserve Bank has gained, over time, a greater degree of operational independence in performing its monetary policy function.

Any modifications required to strengthen the monetary policy as also the regulatory framework might be carried out by necessary amendments to existing legislations as needed, which would not call for a fundamental review of legislations or an overhaul of the existing legal framework.

On the issue of separation of debt management from monetary management, the CFSA notes that the Government is in favour of proceeding with the setting up of a full-fledged DMO. While acknowledging that there could be potential conflicts in objectives and operations between debt management and monetary management and, therefore, for effective discharge of both, functional separation could eventually be desirable, the Chairman personally felt that the time is not yet ripe for the complete separation of debt management from the Reserve Bank, although a well-structured Middle Office could help debt management, as a whole.

The Reserve Bank, SEBI and IRDA are compliant with the relevant standards in transparency in financial policies. The CFSA has concluded that the recommendation made by the Panel to institutionalise the HLCCFM could prove to be counter-productive as it could reduce flexibility in the formulation of financial policies and, hence, has recommended that the present format of the HLCCFM may continue, but with an improvement in the information-sharing mechanism.

The major area of concern arising out of the assessment of fiscal transparency is in the reporting of off-budget items, like oil bonds, and the need to have an augmented fiscal deficit figure to capture these items. Likewise, any move towards accrual accounting should also be attempted in a gradual manner.

Over the years, there have been several gradual improvements in compilation and dissemination of data pertaining to national accounts, fiscal and balance of payments statistics in India. However, there is an urgent need to strengthen the functioning and data dissemination practices of the CSO that have deteriorated in the recent past, as data submission has become a voluntary process. There is also a need to consolidate the process of compiling labour data and this should be done by a professional statistical organisation. As far as price indices are concerned, there is an urgent need to update the weights and include new products in the basket of goods.

Chapter VII

# Development Issues in the Socio-Economic Context

## 7.1 Introduction

A stability assessment of the financial sector should also address key developmental issues that have a bearing on the fair and efficient functioning of financial institutions and markets and the legal/institutional infrastructure. While issues emanating from the analysis of stability have been discussed in the respective chapters on institutions, markets and infrastructure, in the Indian context there are other broader developmental aspects in the socio-economic context affecting social stability which indirectly have a bearing on financial stability.

The social challenge of growth and development goes beyond aspects of human deprivation such as illiteracy, malnutrition, drinking water and sanitation to encompass elements related to economic deprivation, which in the context of the current assessment are areas like financial inclusion, customer service, and access to finance for small-scale industries (SSIs). Thus social stability is very important and has an indirect bearing on financial stability.

The Reserve Bank's Report on Currency and Finance 2006-08 points out that despite the broad international consensus on the importance of access to finance as a crucial poverty alleviation tool, it is estimated that globally over two billion people are currently excluded from access to financial services. The Advisory Panel on Financial Stability Assessment and Stress Testing reviewed current policies and addressed several issues, which are analysed in the following sections. The peer reviewers' comments and the CFSA's observations have been appropriately highlighted.

Social stability is very important and has an indirect bearing on financial stability.

## 7.2 Financial Inclusion

Literature on finance and growth suggests that financial inclusion is one of major determinants of economic growth. Higher economic growth and infrastructure, in turn, play a crucial role in promoting financial inclusion. It

is, thus, argued that in order to achieve the objective of growth with equity, it is imperative that infrastructure is developed in tandem with financial inclusion, as this would facilitate and enhance credit absorptive capacity.

In its research work titled 'Building Inclusive Financial Sectors for Development'[153] (2006), more popularly known as the Blue Book, the United Nations defines financial inclusion as 'a financial sector that provides access to credit for all 'bankable' people and firms, insurance for all 'insurable' people and firms and savings and payments services for everyone.' On a similar note, the Report of the Committee on Financial Inclusion in India (Rangarajan Committee) defines financial inclusion as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups, such as socially weaker sections and low-income groups, at an affordable cost. The Scottish Government (2005)[154] views financial inclusion as the access for individuals to appropriate financial products and services. This includes having the capacity, skills, knowledge and understanding to make the best use of those products and services.

Financial exclusion, by contrast, is the converse of this. Leyshon and Thrift (1995)[155] have defined financial exclusion as the processes that prevent poor and disadvantaged social groups from gaining access to the financial system. Meadows *et al* (2004)[156] define financial exclusion as the potential difficulties faced by some segments of the population in accessing mainstream financial services, such as bank accounts/home insurance. Despite the broad international consensus regarding the importance of access to finance as a crucial poverty alleviation tool, it is estimated that globally over two billion people are excluded from access to financial services (United Nations Blue Book, 2006). The situation is found to be more acute in Less Developed Countries (LDCs), where it is estimated that more than 90 per cent of the population is excluded.

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[153] The book is the result of a project undertaken by the UN Department of Economic and Social Affairs (DESA) and the UN Capital Development Fund (UNCDF) to analyse the obstacles to financial inclusion and to report on efforts to overcome those obstacles in various countries.

[154] The Scottish Government Website

[155] Leyshon, A. and Thrift, N. (1995), Geographies of financial exclusion – financial abandonment in Britain and the United States, *Transactions of the Institute of British Geographers,* Vol. 20 No.3, 312-41.

[156] Meadows, P., Ormerod, P., and Cook, W. (2004), Social networks: Their role in access to financial services in Britain, *National Institute Economic Review*, 189, 99-109.

### 7.2.1 Need for Strengthening Financial Inclusion

The operation of the formal financial system is profoundly important for economic growth and poverty alleviation. A considerable body of evidence indicates that the formal financial system affects aggregate economic growth. Economic growth might lead directly to a reduction in poverty. Alternatively, finance might accelerate growth by disproportionately benefiting the rich without expanding the economic opportunities for the poor. In other words, financial development might increase income inequality. While a small but growing body of evidence, suggests that financial development boosts growth by disproportionately benefiting the poor[157], it is felt that in the Indian context, financial inclusion has to be an urgent national priority to achieve inclusive growth.

Reforms in the financial sector are basically intended to meet two major objectives – profitability of the financial institutions as business entities and serving the needs of the real economy – with due consideration for the principles of equity. However, in the race for profitability, there has been an obvious need to reduce operational costs and, in the process, there is a natural exclusion of several sections of society from the financial net. Reducing the adverse consequences of such exclusion and bringing the maximum number of people under the financial system should be the key focus of financial institutions.

Financial exclusion is a serious concern among low-income households as well as small businesses that are mainly located in semi-urban and rural areas. The consequences of financial exclusion vary, depending on the nature and extent of the services denied. Financial exclusion complicates day-to-day cash flow management – being financially excluded, low-income households as well as micro and small enterprises deal entirely in cash and are susceptible to irregular cash flows. In the case of low-income households, the absence of access to bank accounts and other savings opportunities could result in lack of savings, low investments and lack of financial planning and security for old age. Similarly, such households could also be excluded from the capital market and insurance services. It could also result in difficulties in gaining access to institutional credit. Small businesses could suffer due to loss of access to the middle class and higher-income consumers, higher cash handling costs and delays in remittances of money that lead to a reliance on informal channels of finance for small credits.

It would be incorrect to identify the problem of financial inclusion in India solely as a rural phenomenon. A significant proportion of the urban poor also do not have access to banking facilities. This is particularly evident in respect of migrant labourers who find it difficult to open a bank account as they are unable to comply with KYC norms. While the problem has been

It is incorrect to identify the problem of financial inclusion in India solely as a rural phenomenon.

[157] Levine, R. (2008), Finance, growth, and the poor, *The Financial Development Report*, 27-32, World Economic Forum.

somewhat alleviated after the rationalisation of KYC norms for smaller accounts, more effort in this regard is required (Table 7.1).

**7.2.2. Extent of Financial Inclusion**

There is no single comprehensive measure that can be used to indicate the extent of financial inclusion across economies. Specific indicators, such as the number of bank accounts and the number of bank branches, that are generally used as measures of financial inclusion provide only partial information on the level of financial inclusion in an economy. Bank nationalisation in India marked a paradigm shift in the focus of banking as it was intended to shift the focus from class banking to mass banking. The rationale for creating Regional Rural Banks (RRBs) was also to take banking services to poor people. The branches of commercial banks and RRBs have increased from 8,262 in the year 1969 to 71,471 branches as at the end of March, 2007. The average population per bank branch decreased from 63,000 to 16,000 during the same period. Whether this decline in population per branch has resulted in greater financial inclusion is, however, debatable.

Based on the All India Debt and Investment Survey (AIDIS) 2002, the Rangarajan Committee on Financial Inclusion observed that 111.5 million households had no access to formal credit, 17 million households were indebted to moneylenders, and 45.9 million farmer households in the country out of a total of 89.3 million (or 51 per cent) did not have access to credit, either from institutional or non-institutional sources. The Arjun Sengupta Commission, 2008, on financing enterprises in the unorganised

**Table 7.1: Savings Accounts with Scheduled Commercial Banks**

(End-March)

| | | 1971* | 1981 | 1991 | 2001 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| **Rural** | No. of accounts (million) | - | 56.9 | 153.8 | 169.8 | 194.4 | 213.8 |
| | Accounts per 100 Persons | - | 10.9 | 24.5 | 22.9 | 24.2 | 26.2 |
| | Accounts per 100 Adults | - | 17.9 | 39.2 | 35.0 | 35.8 | 38.8 |
| **Urban** | No. of accounts (million) | - | 40.9 | 99.2 | 110.2 | 149.1 | 159.7 |
| | Accounts per 100 Persons | - | 25.7 | 45.6 | 38.5 | 48.1 | 50.7 |
| | Accounts per 100 Adults | - | 42.3 | 73.1 | 58.9 | 71.4 | 75.2 |
| **Total** | No. of accounts (million) | 23.6 | 97.8 | 253.0 | 280.0 | 343.4 | 373.5 |
| | Accounts per 100 Persons | 4.3 | 14.3 | 29.9 | 27.2 | 30.8 | 33.0 |
| | Accounts per 100 Adults | 7.1 | 22.9 | 46.8 | 41.5 | 45.9 | 48.9 |

* As at end-June

**Source:** Report on Currency and Finance, 2006-08.

Whether the decline in population per branch has resulted in greater financial inclusion is debatable.

sector has observed that in spite of contributing 30 per cent to GDP, non-farm unorganised sector enterprises receive only 5-6 per cent of total institutional credit.

The Arjun Sengupta Commission Report further pointed out that only 2.4 million out of 58 million units in this sector (with an investment of less than Rs 25,000) have accessed credit from commercial banks. The Invest India Incomes and Savings Survey (2007) has indicated that only 32.8 per cent of households borrowed from institutional sources and 67.2 per cent borrowed from non-institutional sources. The dependence on non-institutional sources of finance was particularly evident in poorer households within the income bracket of less than Rs. 25,000.

### 7.2.3 Current Scenario

#### 7.2.31 International Comparisons

The focus of financial inclusion in India has progressed from ensuring a bare minimum access to a no-frills savings bank account for the unbanked population to the concept of 'Total Financial Inclusion', which involves meeting the entire credit requirements of self-help group members, namely, (a) income generation activities, (b) social needs like housing, education, and marriage and (c) debt swapping.

Internationally, however, financial exclusion has been viewed from a wider perspective. There is both widespread and mounting concern about access to banking services across most developed nations in Europe and North America as well as Australasia. The most common responses to financial exclusion are voluntary charters and codes of practice that are developed by the banks themselves through their trade associations to provide 'life-line' or 'basic' bank accounts. In many cases, these developments have been prompted and encouraged by the concerned governments to increase social inclusion.

The World Bank's Investment Climate enterprise surveys (conducted in almost 60 countries) have explored questions of financial sector access by the

**Table 7.2: Credit Accounts with Scheduled Commercial Banks**

(End-March)

| | | 1971* | 1981 | 1991 | 2001 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| **Rural** | No. of accounts (million) | - | 16.4 | 49.9 | 36.6 | 50.5 | 53.1 |
| | Accounts per 100 Persons | - | 3.1 | 7.9 | 4.9 | 6.3 | 6.5 |
| | Accounts per 100 Adults | - | 5.2 | 12.7 | 7.5 | 9.3 | 9.6 |
| **Urban** | No. of accounts (million) | - | 4.4 | 12.1 | 15.8 | 34.9 | 41.3 |
| | Accounts per 100 Persons | - | 2.7 | 5.5 | 5.5 | 11.3 | 13.1 |
| | Accounts per 100 Adults | - | 4.5 | 8.9 | 8.4 | 16.7 | 19.5 |
| **Total** | No. of accounts (million) | 4.3 | 20.7 | 61.9 | 52.4 | 85.4 | 94.4 |
| | Accounts per 100 Persons | 0.8 | 3.0 | 7.3 | 5.1 | 7.7 | 8.3 |
| | Accounts per 100 Adults | 1.3 | 5.0 | 11.7 | 7.9 | 11.6 | 12.4 |

* As at end-June

**Source:** Report on Currency and Finance 2006-08.

The focus of financial inclusion in India has progressed from ensuring a bare minimum access to a 'no-frills' account for the unbanked population to the concept of 'total financial inclusion'.

### Box 7.1: Financial Inclusion – Experience in Select Economies

The Grameen Bank (GB) was launched as a project in a village of Bangladesh in 1976 to assist poor families by providing credit to help them overcome poverty. The interest rate charged by the Grameen Bank is lower than that fixed by the Government of Bangladesh. It is owned by the poor borrowers of the bank who are mostly women. GB has created a banking system based on mutual trust, accountability, participation and creativity. It provides credit to the poorest of the poor in rural Bangladesh, without any collateral or legally enforceable contracts. It offers credit for creating self-employment, income-generating activities and housing for the poor, as opposed to consumption. As of March, 2008, it had 7.46 million borrowers, 97 per cent of whom were women. With 2,504 branches, GB provides services in 81,574 villages, covering more than 97 per cent of the total villages in Bangladesh.

The Financial Inclusion Task Force in the UK has identified three priority areas for the purpose of financial inclusion, *viz.*, access to banking, access to affordable credit and access to free face-to-face money advice. The UK has established a Financial Inclusion Fund to promote financial inclusion and assigned responsibility to banks and credit unions in removing financial exclusion. Basic no-frills bank accounts have also been introduced. An enhanced legislative environment for credit unions has been established, accompanied by tighter regulations to ensure greater protection for investors. A Post Office Card Account (POCA) has been created for those who are unable or unwilling to access a basic bank account. The concept of a Savings Gateway has been piloted; this offers those on low-income employment £1 from the state for every £1 they invest, up to a maximum of £25 per month. In addition, Community Finance Learning Initiatives (CFLIs) were introduced to promote basic financial literacy among housing association tenants.

A civil rights law, namely, the Community Reinvestment Act (CRA) in the United States, prohibits discrimination by banks against low and moderate income neighborhoods. The CRA imposes an affirmative and continuing obligation on banks to serve the needs for credit and banking services of all the communities in which they are chartered. In fact, numerous studies conducted by the Federal Reserve and Harvard University demonstrated that CRA lending is a win-win proposition and profitable to banks. In this context, another initiative has been taken by a state in the United States; armed with the sanction of Banking Law, the State of New York Banking Department, with the objective of making available low-cost banking services to consumers, made it mandatory for each banking institution to offer basic bank accounts and, in the case of credit unions, the basic share draft account, which is a low-cost account with minimum facilities.

The earliest voluntary charter was introduced in France in 1992. Developed by the French Banker's Association, it committed banks to opening an affordable account with facilities, such as a cash card, free access to a cash machine network, bank statements and a negotiable number of cheques.

In Belgium, a voluntary code of practice was introduced in July 1997 by the Belgian Bankers Association (ABB/BVV) following a report commissioned by the Ministry for

Economic Affairs. This code provides basic banking services for people on modest incomes who lack a bank account.

In Germany, due to numerous attempts to introduce a legal entitlement to a current account that did not carry an overdraft facility, a voluntary code was introduced by the German Bankers Association in 1996. This makes provision for an 'Everyman' current account that offers basic banking transactions but without an overdraft facility. Figures submitted by the banking industry to the Bundestag (German National Parliament) show that between June 1996 and June 2000 more than 800,000 'Everyman' accounts had been opened – an increase of 350 per cent.

In many ways, the policy response in Canada combines the best of developments in other countries. The federal Government set up a task force on the future of the Canadian financial services sector, which published its report in 1998. In 1999, the Government responded with a report (Department of Finance, Canada, 1999) setting out 57 reform measures, which were then included in legislation put before Parliament. Bill C-8 was enacted in June, 2001 and includes new rules designed to tackle banking exclusion. These include rules requiring all banks to provide accounts without minimum opening balances to all Canadians, regardless of employment or credit history, with minimum identification requirements. Significantly, the Act also includes rules allowing the Government to make regulations regarding the provision of low-cost accounts. Eight banks have signed a Memorandum of Understanding with the Government pledging to offer low-cost accounts to their customers.

**Source:** Report on Currency and Finance 2006-08, www. www.financialinclusion-taskforce.org.uk, other Government websites.

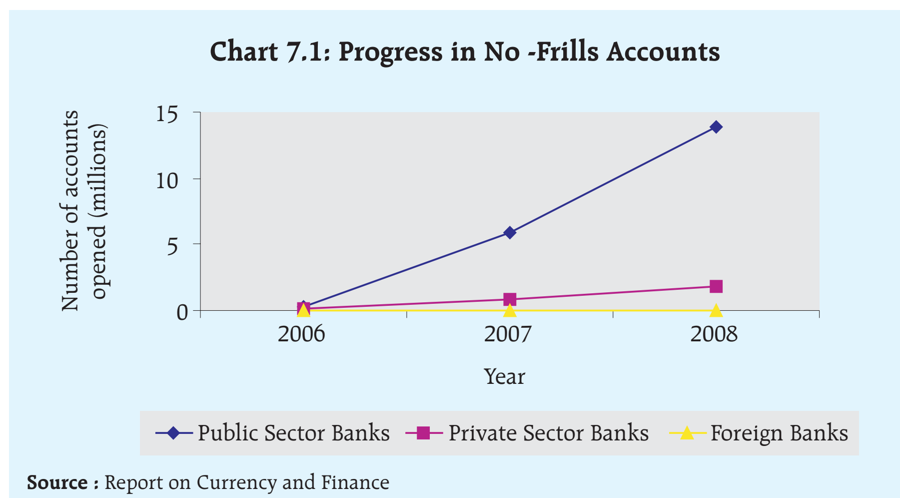
surveyed companies. The World Bank's 'Doing Business' surveys have also covered expert assessment of certain elements of financial access in as many as 145 countries.

The recent Financial Development Index 2008 Rankings by the World Economic Forum (covering 52 countries) has also indicated 'access' as an important element of development indicators. India's ranking both in ease of access to credit and ease of access to the local equity market has been high at 10, indicating its strength. The rankings in respect of other components of access were: financial market sophistication (26), venture capital availability (21), bank branches (38) and ease of access to loans (25).

**7.2.32 No-frills Accounts and Credit Cards**

The Annual Policy for 2005-06 announced that, in the interests of financial inclusion, banks were to open 'no-frills' or a basic banking account to all those desirous of opening a bank account. Several other aspects, such as simplified KYC, One Time Settlement for loans up to Rs 25,000, and General Credit Cards/simplified overdrafts were also covered. A decentralised approach was advocated through targeting 100 per cent financial inclusion district-by-district, involving the DCC and bank and government officials, to facilitate enrolment and identification. In January 2006, banks were allowed to adopt the agency model or what is known as the Business Facilitator/Business Correspondent model to achieve greater outreach through intermediaries/agents The number of no-frills accounts

India's ranking both in ease of access to credit and ease of access to the local equity market has been high




opened by banks has increased from around half a million accounts in March 2006 to 15 million in 2008 (Chart 7.1).

In order to promote credit to the agricultural sector and rural and semi-urban areas, banks have been permitted to introduce Kisan Credit Cards (KCC) and General Credit Cards (GCC) which are issued based on an assessment of the income and cash flow of households. By 2006-07, more than 660 lakh KCCs and close to 3 lakh GCCs had been issued.

Evaluation by external agencies appointed by the Reserve Bank has shown that, while the first stage of opening no-frills accounts has been quite impressive, in many cases the accounts have not been operated at all after having been opened. In order to improve access and use of these accounts, banks will have to offer the services closer to the customer either through mobile branches, satellite offices, extension counters or intermediaries like Self-Help Groups (SHGs) and Micro-Finance Institutions (MFIs), or through business correspondents using IT to increase scale and access and reduce cost. The credit product has to be simple, covering all the needs of small borrowers, and could be met by providing a simple overdraft or GCC.

No frills accounts are opened but often not operated afterwards

### 7.2.33 Self-Help Groups and Micro-Finance Institutions

In light of the inefficiencies that characterise the rural financial market and the relative lack of success of formal rural financial institutions in delivering finance to the poor, manifold efforts have been undertaken to develop new and informal delivery approaches. The cost of informal borrowing is significantly higher than the borrowings from banks (Table 7.3).

| Table 7.3: Cost of Credit from Various Agencies in India | |
|---|---|
| **Lender Category** | **Interest Rate (per cent per annum)** |
| SHGs | 18-24 |
| MFIs | 20-24 |
| Informal credit providers | 18-36 |
| Banks (small borrowal accounts) | 6-20 |

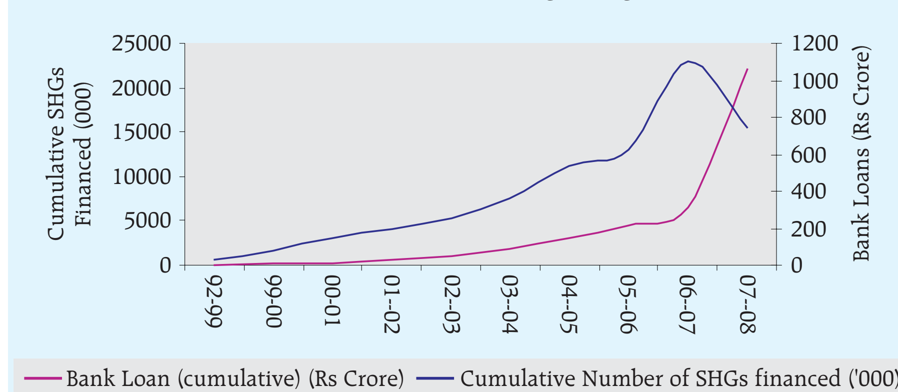
**Source:** RBI Report on Currency and Finance, 2008.

In this context, the Arjun Sengupta Commission is of the view that increased involvement of commercial banks in micro-financing is essential for a sustainable micro-financing programme in the country. The constraints which inhibit micro-finance from graduating to micro-enterprise financing should be removed through methods like support to build assets to run the enterprise, increasing product mix by adding insurance and money transfer, providing livelihood finance for essential infrastructure requirements and capacity building of SHGs, MFIs, and NGOs.

One approach in micro-finance that has gained prominence is the Self-Help Group (SHG) Bank linkage programme. The linkage involves organising the poor into small, cohesive groups and inculcating a savings habit within the group. The group is linked to a bank and the saved and borrowed funds are rotated through lending within the group. The lenders (banks) are often refinanced by NABARD at competitive rates. In spite of the constraints, SHGs and MFIs constitute the fastest growing segment in recent years to reach out to small borrowers (Chart 7.2).

Similar approaches include the Micro-finance Institution-Bank linkage programme, NBFC-Bank linkage programme, Post office-Bank linkage programme and the NBFC-Market linkage programme. Unlike the banking sector, these approaches do not have the benefits of insurance or membership in the payment and settlement system. An added hindrance is the lack of required skills and local knowledge to promote and maintain groups to ensure quality and the cost of group formation.

**Chart 7.2 : SHG-Bank Linkage Programme**




**Source :** Report on Currency and Finance

In spite of the evidence that an increase in microfinance lending is associated with a lower incidence of borrowing from moneylenders, especially for low-income segments, and that in the lowest income category respondents who are members of SHGs appear to borrow less from moneylenders and friends and family than those who are not members of SHGs, the prevalence of money lenders in the rural financial sector continues to be significant. This is because money lenders are powerful and exert influence in their region; also, unlike institutional lenders, they extend finance even for consumption purposes and without requiring any collateral. Moreover, money lenders provide timely credit at the doorstep, which is more important to the borrower than its associated costs[158].

The findings of a survey undertaken by India Invest Market Solutions (IIMS) (July 2007), wherein respondents reported loans taken from various agencies during the preceding two years of the survey date, are placed below (Table 7.4).

Money lenders provide timely credit at the doorstep, which is more important to the borrower than its associated costs.

**Table 7.4: Sources of Loans by Income Groups**

(per cent of indebted earners ^)

| Loan Agencies / Annual Income Range | | Less than Rs 50,000 | Rs 50,000 to Rs 1,00,000 | Rs 50,000 to Rs 1,00,000 | Rs 50,000 to Rs 1,00,000 | Rs 50,000 to Rs 1,00,000 | TOTAL |
|---|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| **I.** | **Institutional Sources** | **27.5** | **46.0** | **59.4** | **60.2** | **70.5** | **32.8** |
| | (i) Banks | 13.0 | 34.5 | 49.3 | 51.6 | 62.8 | 19.1* |
| | (ii) Co-operative societies | 4.9 | 6.7 | 8.6 | 3.6 | 4.1 | 5.3 |
| | (iii) Micro-finance institutions | 1.1 | 1.0 | 0.7 | 0.5 | 2.4 | 1.1 |
| | (iv) Self-help groups | 8.5 | 3.9 | 0.8 | 4.5 | 1.2 | 7.3 |
| **II.** | **Non-institutional sources** | **72.5** | **54.0** | **40.6** | **39.8** | **29.5** | **67.2** |
| | (i) Relatives/friends | 35.1 | 32.1 | 26.5 | 22.2 | 22.1 | 33.9 |
| | (ii) Moneylenders | 34.9 | 19.6 | 12.0 | 11.8 | 5.5 | 30.8 |
| | (iii) Others | 2.5 | 2.3 | 2.1 | 5.8 | 1.9 | 2.5 |
| **III.** | **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

^ : An earner is defined as a person who is in the age group 18-59 years and getting some cash income

* : As per the survey, around 15 million earners took loans from banks, which is comparable with around 17 million additional credit accounts opened by banks during 2005-07, as per BSR data.

**Note** : Cells may add up to more than 100 per cent due to borrowing from multiple sources by respondents.

**Source :** RBI Report on Currency and Finance 2006-08.

[158] Arjun Sengupta Committee Report on Financing Enterprises in the Unorganised Sector.

#### 7.2.34 Other Institutions

There are three other sets of institutions that contribute to financial inclusion:

*Rural and co-operative financial institutions*

Other than scheduled commercial banks, the rural and co-operative financial institutions are the largest conduits for financial inclusion. Taken together, they accounted for nearly 30 per cent of the total number of savings accounts with financial institutions.

*Post Offices*

Post offices in the country also provide services of deposit maintenance and remittances. With a network of about 1,55,600 offices across the country, a post office in India served on an average 7,046 persons as at end-March 2005. Their focus is small-ticket deposits and they have introduced a variety of small savings schemes. They also provide various types of remittance facilities in the form of domestic money orders and other remittances. Post offices accounted for around 10 per cent of the total number of savings accounts with institutions.

*Insurance Sector*

There is a need to expand access to insurance to the rural and urban poor. The Insurance Regulatory and Development Authority (IRDA) has been actively encouraging insurance services for low-income households and establishing rural and social sector targets for insurance companies in a phased manner. In India there are around 3.1 policies per thousand persons. Though this appears low compared to advanced economies, the penetration is significantly higher when compared to several emerging market economies.

#### 7.2.35 E-Choupal

Another initiative, e-choupal, uses desktop computers with internet connectivity to deliver real-time information and customised knowledge to improve farmers' decision-making ability, thereby better aligning farm output to market demands; securing better quality and productivity; and promoting improved price discovery. The e-choupal is also a mode to seek technical advice, obtain weather forecasts and order agricultural inputs. In addition, they provide potential avenues for lenders, agricultural commodity traders and farmers to interact in a relatively seamless manner, with low transaction costs and improved (credit and market) information. Though not directly connected to financial inclusion, e-choupals could help increase financial literacy and awareness among the rural population. This could be further buttressed through the introduction of e-kiosks that provide information on financial products and services to under- banked areas.

Financial education could be buttressed through e-kiosks.

### 7.2.4 The Way Forward

India has been adopting a multi-pronged approach towards financial inclusion. Though a wide network of institutions have been established in order to expand the outreach of financial services to people, the magnitude of the problem continuous to be enormous with a sizeable low income population still denied access to financial services. Hence, sustaining and improving upon the financial inclusion process would be a major challenge in the days to come.

### 7.2.41 Rangarajan Committee on Financial Inclusion

The Rangarajan Committee on Financial Inclusion observes that exclusion is most acute in the central, eastern and north-eastern regions. The Committee recommends a four-pronged strategy for building an inclusive financial sector: (a) effecting improvements in the extant formal credit delivery mechanism; (b) suggesting measures to improve credit absorption capacity, especially among marginal and sub-marginal farmers; (c) evolving new models for effective outreach; and (d) leveraging technology-based solutions. The entire gamut of these recommendations would need to be reviewed and implemented in a phased manner so as to promote and achieve financial inclusion.

### 7.2.42 Assessing the Need for Financial Inclusion

In the context of financial inclusion, it is important to know the extent to which low income households are excluded from the formal financial system. There is a need for specialised and detailed household surveys to have census data on the number and characteristics of households that have a bank account or an account with institutions like banks. Either separate surveys relating to financial inclusion/exclusion may be conducted or the scope of the indebtedness survey by the NSSO could be expanded to include various aspects of financial inclusion/exclusion. Besides the periodic surveys, the decadal census may also cover information relevant to financial inclusion/exclusion. Such specialised surveys would enable appreciation of the extent of the problem and would help design appropriate policies to close the gap.

Data collection to estimate the extent of financial exclusion is important.

Though there are also a large number of MFIs/NGOs operating in the country, there is no comprehensive system for collecting data/information on various aspects of these institutions. There is, therefore, a need for a comprehensive system of data collection on MFIs/NGOs as well as information on the number of households being financed by MFIs/NGOs to be collected, which would help appropriate policy formulation.

### 7.2.43 Financial Inclusion as an Opportunity

Financial inclusion needs to be perceived as an opportunity for expanding business in the medium term, notwithstanding initial costs. There is also a need to recognise the vast potential for investment in agriculture and allied activities and the entire supply chain. Large industrial corporates have been engaging in contract farming and direct marketing of rural products and services. Manufacturing activities have also picked up. In view of the evidence of a pick-up in consumer financing in rural areas, there is also a need to streamline the supply chain to deliver credit at the lowest cost to the ultimate user in the rural areas, to the benefit of both the bank and the borrower. Furthermore, there are huge opportunities in the area of farmer's insurance as new and untried technology is being adopted and increased input intensities expose them to larger risks. Hence there exists a vast scope for enhancing business opportunities for banks and financial institutions in the rural areas.

Mutually beneficial linkage between local institutions and bigger players could enhance financial inclusion.

### 7.2.44 New Design Principles and Products

Another approach towards greater financial inclusion is to explore new design principles. Local financial institutions could serve as the client interface; they could tie up with partner financial institutions (such as public or private banks) by forming mutually beneficial linkages (using a partnership model or business correspondent model), as an insurance against idiosyncratic risks relating to the specific geography in which they operate. The associated synergies ensure that the national-level financial entity is able to lower its cost of providing financial services by allowing it to operate without having to invest in rural branches.

Financial inclusion can be enhanced through introducing products that are tailored to the needs of small borrowers. The challenge for banks lies in offering such low-income households and unorganised enterprises a simple loan product which is not based on or linked to the purpose of the loan, the collateral or assets held, or income earned by the household, but is purely based on the cash flow and credit record of the household[159]. For such initiatives to succeed, the unbanked population needs to imbibe a credit culture, especially in semi-urban and rural areas. The necessary conducive climate can be created by improving financial literacy and simplifying banking procedures.

### 7.2.45 Technological Innovations

It is a daunting task to extend banking to rural areas where there are limited or no bank branches, and a lack of consistent power supply and communication links, such as telephones or the internet. This calls for new approaches to take banking to remote regions. Further, cash management in rural India is still a problem since its transportation is expensive as well as unsafe. Instead of opening full-blown brick-and-mortar bank branches in

Simple loan products, linked only to the cash flow and credit record of the household, are needed.

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[159] Financial Inclusion and Information Technology. Keynote address by Smt. Usha Thorat, Deputy Governor, Reserve Bank of India at '*Vision 2020 – Indian Financial Services Sector*'.

IT-enabled banking services can help with increasing financial inclusion.

remote districts, which might not be very cost-effective, banking functionalities could be extended to remote regions with the help of information technology solutions that deliver banking services and reduce transaction costs, as well as with the help of the good managerial skills of business correspondents.

IT-enabled banking services have the potential for effectively meeting the challenge of reaching out to financially excluded customers, especially in rural areas. Banks have been urged to rapidly scale up their IT initiatives for financial inclusion, while ensuring that solutions are highly secure, amenable to audit and follow widely-accepted open standards to ensure eventual inter-operability among the different systems.

To reach out to the rural population, some Indian banks have initiated a process where biometric smart cards are provided to their customers. To facilitate the process, the banks hire business correspondents who interact with customers. While this is a welcome step to enhance financial inclusion, the CFSA feels that the process needs to be examined from a holistic perspective, taking into account both risks and returns in the interests of its long-term viability. The CFSA in this context notes that there are already some initiatives to migrate from smart cards to a cardless process, which is expected to control costs.

Business Correspondents need to be made aware of the intangible synergies to their existing business lines.

Another issue is to suitably incentivise the business correspondents (BCs) to popularise the process. In this context, CFSA feels that the BCs need to be made aware of the intangible synergies in terms of more awareness of their existing lines of business and increased footfalls that are associated with their involvement with the project. At the same time, the inherent risks of employing BCs need to be mitigated by applying proper due diligence in their appointments and continued monitoring of their activities. Further, the CFSA believes that the eligibility conditions for BCs need a fresh look with the objective of relaxing the conditions in a controlled manner. Large numbers of BCs need to be recruited and the need to make them financially viable is paramount to making the BC model effective. Villages have large numbers of retailers and dealers of consumer goods or mobile phones/recharge vouchers who can be tapped as BCs. Alternatively, large reputed companies that have huge distribution networks in the form of dealer networks could be licensed as BCs with adequate safeguards and 'fit and proper' evaluation.

While the currency to broad money ratio has been showing a secular decline, since a large proportion of the population still remains unbanked and

depends on cash transactions for their day-to-day financial needs, there is a consistent growth in public demand for currency. Taking advantage of the sizable penetration and popularity of mobile telephony across the country (including among the low-income population) and linking it to transact banking business could not only help improve financial inclusion, but would also help diminish the demand for currency in the country and the need for expensive printing and distribution of the same.

'Mobile Banking' is a term used for checking account balances and performing account transactions and payments via a mobile device, such as a mobile phone or Personal Digital Assistant (PDA). These services are gaining popularity in micro-payment scenarios by extending financial services through accounts which can be operated virtually. This technology has the potential to significantly lower transaction costs, while expanding outreach to rural areas. Mobile banking is an appealing prospect to usher in financial inclusion because of the falling costs of mobile phones including airtime, competition and the ability of electronic banking solutions to offer customers an enhanced range of services at a very low cost. It is also beneficial for the bank, which can increase its outreach to rural areas while reducing its costs. Mobile banking could eventually allow users to make payments at the physical point of sale (POS).

A key challenge in developing a mobile banking system, however, is the lack of standardisation. Lack of standards for mobile banking and the adoption of different technologies have led to isolated projects across the globe. Moreover, the security of financial transactions being executed through mobile telephony and the transmission of financial information are challenges that need to be addressed. Another challenge for the banks is to scale up the mobile banking infrastructure to handle exponential growth of the customer base. Banks that are unable to meet performance and reliability expectations could lose customer confidence. There is a need to address other issues, including the relationship between the telephone service provider and the banking system and the development of appropriate risk management skills, and, hence, a mechanism needs to be developed to regulate and supervise the growth of mobile banking in India. The Reserve Bank had placed a paper on mobile banking in the public domain. In order to ensure a level playing field and given that the technology is relatively new, the Reserve Bank has brought out a set of operating guidelines on mobile telephony for adoption by banks. Apart from regulatory and supervisory issues, the guidelines cover areas like registration of customers, technology and security standards, inter-operability, clearing and settlement for inter-bank funds transfer transactions, customer complaints and grievance redressal mechanisms.

A key challenge in developing a mobile banking system, is the lack of standardisation.

Further, the task of reaching out to large numbers of customers in the hinterland, establishing a robust BC network, and ensuring reliable delivery of services is quite onerous and huge. Banks may need to partner with

Banks should be allowed/ encouraged to form partnerships with business correspondents (BCs) provided that risk management issues like KYC and AML are fully under banks' control.

appropriate technology firms to create the infrastructure, select the product offering, and manage service delivery. Banks should be allowed/encouraged to form such partnerships provided that risk management issues like KYC and AML are fully under the bank's control and depositors' funds are always with the bank.

Given the enormity of the task of financial inclusion and the need to spur innovation and entrepreneurship to achieve the same, one approach is to license mobile wallet service providers that are non-banks; they can be licensed to offer mobile wallet services under strict regulatory conditions like capital adequacy, transaction and wallet-size restrictions, and meeting KYC and AML norms. Many countries are experimenting with such guidelines, and the European Union has had e-money guidelines for a long time. Such guidelines could allow the creation of services like M-PESA in Africa that are phenomenally successful. Mobile wallets could offer payments between two individuals, at POS, bill payments, and domestic remittances along with small savings. The mobile wallet service could be ideal for rural small-ticket customers.

**7.2.46 Inclusion for the Urban Poor**

It is estimated that more than 40 per cent of the adult Indian urban population has no access to a bank account, thereby depriving them of savings, credit, remittance and other financial service facilities from the formal financial system. Urban India has a huge poor migrant population, which needs a fast, low-cost, convenient, safe and widely accessible remittance service that allows them to send money to their families and dependents to meet their consumption and other life-cycle needs. Institutions hesitate to provide financial services to the urban poor for several reasons – lack of identity proof, lack of cohesion among the inhabitants of urban slums, irregular incomes and migration to and from rural areas; this is in contrast to the rural poor who have the permanent address proof needed for requisite documentation. While KYC norms have been significantly rationalised in recent times, they may need to be further rationalised along with incentivising banks to reduce costs in order to provide services to this customer group. With the implementation of employment/income generation schemes for disadvantaged groups, such as the Prime Minister Rozgar Yojna (PMRY) and Swarna Jayanti Shahari Rozgar Yojna (SJSRY), one option is the formation of joint liability groups (JLGs) among the urban poor that allows them to obtain bank credit with collective obligations for interest

The mobile wallet service could be ideal for rural small-ticket customers.

and loan repayments. Similarly, those among the urban poor who are determined to save regularly, even with their low earnings, should be provided an investment option that fetches a good rate of return on their savings.

The poor migrant population in urban India should be provided with financial services.

**7.2.47 Addressing Cost Constraints – Ensuring Adequate Returns**

A major reason for the increase in overall household debt and the increase in the share of households indebted to non-institutional sources between 1991 and 2002 has been the significant increase in current farm expenditure and household (non-productive) expenditure, especially in rural areas. Such 'household expenditure' includes many items for which households may find it difficult to obtain finance from institutional sources and, hence, they seek recourse from informal non-institutional sources at exorbitant rates of interest, often heading into a debt trap. In order for banks to be effective conduits for achieving the goals of financial inclusion, such household expenditure would also need to be financed by banks.

The Arjun Sengupta Commission Report has recorded some disturbing trends with regard to credit to small enterprises. These include the insistence by banks on collaterals for loans up to Rs.5 lakh in spite of the Reserve Bank's instructions on priority sector lending to the contrary; the banks are uninterested in advancing loans under the Credit Guarantee Scheme available for loans up to Rs 25 lakh. The Commission has also observed bank apathy in propagating and adopting the agency models of business facilitators and correspondents to extend the coverage of credit to neglected areas and segments of society, which is further hampered by severe staff shortage in rural area branches.

One reason banks are not enthused about providing banking services to the poorer segment of the population is that they may consider these advances as unviable. In order to promote financial inclusion, it is essential that banks are in a position to cover their incurred costs.

From the lender's perspective, the formal financial sector incurs three kinds of costs while extending credit: (a) cost of funds, (b) operating cost and (c) cost of non-performing loans. Financial inclusion is hampered by the large costs of covering the huge numbers (cost of enrollment), relatively high maintenance costs for such accounts, small ticket size for each transaction, affordability of the product or service, need for local acceptance and involvement of locally acceptable personnel, need for communication modes suited to the illiterate and in the local language, and need for large-scale coverage including difficult geographic terrain and areas that do not have electricity or telecommunication facilities.

Banks should be able to cover their costs of practising financial inclusion.

An Internal Working Group set up by the Reserve Bank to look into the recommendations of the Arjun Sengupta Commission is of the view that the cost of credit should be affordable and reasonable for non-agricultural purposes. It observed that in light of the need to improve the risk assessment

capabilities of banks and the proposed setting up of credit information bureaus in the country, the risk assessment capabilities of the banks would increase and transaction costs would decline. It therefore recommends the establishment of credit information bureaus and improvement in risk assessment in order to lower transaction costs for banks. The Group is also of the view that if a reasonable cost for doorstep services can be recovered from customers, banks may be incentivised to adopt the agency model. The Panel on Financial Stability Assessment and Stress Testing feels that banks need operational flexibility to decide the interest rate charged to small customers, so that they can cover costs. It needs to be mentioned that even if banks charge an interest rate that is higher than BPLR, this would still be lower than that charged by non-institutional sources and micro-finance institutions.

**7.2.48 Credit Registries**

The accelerated growth of the MFIs sector in the last few years, though a boon for financial inclusion, is not without problems as cases of multiple lending to the same borrower have surfaced. In order to avoid such cases of multiple financing, there is a need to put in place a system of credit registries (through which lenders share information about their clients' repayment records) through credit information bureaus similar to those available for the large corporates. Credit registries could increase access by establishing credit records of borrowers. This could be undertaken by credit information companies.

**7.2.49 Regulatory Measures**

The Government and the Reserve Bank have taken several initiatives to bring the underprivileged and weaker sections of society within the banking fold. However, given the magnitude of financial exclusion in the country, further efforts are required. To start with, financial literacy and awareness needs to be taken up in a big way. With the objective of mainstreaming the activity of moneylending as also strengthening the synergies between the formal and informal segments, the model legislation suggested by the Technical Group to Review the Legislation on Money Lending (2007) needs to be implemented. It is also to be explored whether banks may be assessed on their performance relating to financial inclusion, and rated accordingly. Finally, the Government has an important and crucial role in assisting financial inclusion through strengthening the rural infrastructure and facilitating the production and distribution of output.

With regard to the need to improve the outreach and expand the accessibility of banking services in rural areas, the Internal Working Group feels that each State Level Banking Committee (SLBC) may be required to examine areas that need the physical location of branches and that the State Government should assist banks in opening branches at these centres.

The lender needs to have in place appropriate credit risk mitigation techniques, and to take into account aspects related to security concerns and fraud prevention. Also, as suggested by the Arjun Sengupta Commission, there should be a provision for adequate safety nets to the banks for such functions in the form of a credit guarantee corporation.

### 7.3 Access to Finance by Small-Scale Industries (SSIs)

Small-scale industries (SSI) constitute an important segment of the economy in terms of their contribution to the country's industrial production, exports, employment and creation of an entrepreneurial base. Despite their dominant numbers and importance in job creation, SSIs have traditionally faced difficulty in obtaining formal credit or equity. The share of credit to SSIs declined from around 15 per cent in 1998 to less than 7 per cent in 2007, while their share in GDP has remained at around 13 per cent. Commercial banks have a tendency to prefer large corporate borrowers, who provide better business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the bank. When banks do lend to SSIs, they tend to charge a commission for assuming risk and apply tougher screening measures, which drive up overall costs.

A well-functioning and sustainable mechanism for SSI financing requires institution building and a market-based approach. Lending institutions must improve their ability to provide financial services to SSIs through commercial mechanisms that lower costs and minimise their risk exposure. Reducing the transmission costs of evaluating SSI credit could be one way to level the playing field.

A sustainable mechanism for SSI financing requires institution building and a market-based approach.

### 7.4 Customer Service

In India, the range of customers varies from sophisticated corporates and high net worth individuals to low-end borrowers who are catered to by micro-finance initiatives. Offering customised solutions to such diverse customer groups is a challenge. Moreover, changing customer expectations also presents a tough task for banks, which are in the process of migrating to the next rung of best practices with regard to customer service.

The issue of services rendered by banks to the common person engaged the attention of the Talwar Committee (1975) and the Goiporia Committee (1990). More recently, the Committee on Procedures and Performance Audit of Public Services has highlighted the need to strengthen customer service in banks and has suggested various mechanisms for improvement. The Reserve Bank, Indian Banks' Association (IBA), Banking Standards and Codes Board of

India (BSCBI), the Banking Ombudsman and the commercial banks too have been focusing on customer service in banks.

Over time, a series of initiatives have been taken regarding the institutional mechanism within as well as outside banks to improve the quality of customer service. Some of these measures are grievance redressal through the Banking Ombudsman Scheme, setting up Customer Service Committees at various hierarchal levels within the bank, a voluntary code of banks' commitment to customers through the BSCBI, setting up a Customer Service Department within the Reserve Bank, formulation of a Fair Practices Code for Lenders, improving the level of financial literacy and financial education among consumers, and instructions to banks on transparency and reasonableness of banking services. In spite of these initiatives, there are gaps in the implementation of guidelines which give rise to customer grievances. Lack of appropriate and efficient information dissemination channels between the banks' head offices and their corresponding branches often leads to inadequacies in service. Limited awareness of customer rights is another area which needs to be addressed. Customer service by banks could, therefore, be improved through measures like financial education, credit counselling and improvement in information dissemination.

Developing a database of customers is the bedrock on which banks can develop value-added customer service. Hence, codifying the data in a form that is amenable to customising service requirements across a vast spectrum of customers should be a priority. In this context, appropriate 'relationship pricing' strategies would help induce better customer service. The Panel stresses the intensive and focused use of technology to leverage the customer database, and relationship pricing to tailor products and services in line with customer demands. The Panel is also of the view that banks that fail to achieve a threshold minimum rating on customer service should be denied privileges in terms of branch licensing. The CFSA is of the view that while there is a need for banks to develop customer databases so that they can tailor products and services in line with customer needs, the risks associated with maintaining the confidentiality of such data and preventing identity theft need to be addressed through proper control mechanisms.

There should be proper control mechanism to mitigate risks associated with maintaining customer data base.

The CFSA notes that there has been an ongoing debate on the choice between a statutory regulation and self-regulation for oversight of customer service. Statutory regulatory instructions are set out in letter, but sometimes may not be carried out in spirit. On the other hand, self-regulation can often

be more effective in dealing with deficiencies in service, but by itself may not be a fully effective tool for raising standards of customer service. In this regard, Shri V. Sundararajan, peer reviewer, is of the view that it is the responsibility of the board and management of the concerned financial institution and numerous bank-level committees to handle compliance with customer service. He feels that there is no need for heavy supervision. The CFSA is of the view that as long as the basic principles for treating customers fairly like transparency, reasonableness, integrity in selling, confidentiality, assistance when needed and an effective grievance redressal machinery are being followed, whether a statutory or self-regulatory route is followed is not material to achieving the desired objectives.

## 7.5 Sustainability Issues

Sustainable development of the financial sector is a key element for risk assessment. Sustainability combines environmental, social, ethical and governance factors. It defines business excellence, innovation and the licence to operate as a financial institution. Banks need to develop a culture of Socially Responsible Investing (SRI). Globally, several countries have undertaken pro-active measures towards undertaking responsible investments. In the Indian context, some banks have developed a fund to generate long-term capital growth from an actively managed portfolio of equity and equity-related securities, primarily of socially responsible companies focusing on sustainable development. With the launching of the S&P ESG (Environmental, Social and Corporate Governance) India Index in January 2008 (comprising 50 Indian companies that meet certain ESG criteria and drawn from the largest 500 companies listed on the NSE through a two stage screening process), the aspiration among companies to rank well on this index would motivate them to enhance their sustainability disclosure standards.

## 7.6 Summary

In the Indian context, an analysis of stability should include other broader developmental aspects in the socio-economic context that affect social stability which indirectly have a bearing on financial stability. The social challenge of growth and development includes areas like financial inclusion, customer service and access to finance for SSIs.

Bank nationalisation in India marked a paradigm shift in the focus of banking from class banking to mass banking. The co-operative sector, RRBs and post offices are other major conduits to promote financial inclusion. There is a need to expand access to insurance by the rural and urban poor. The dependence on non-institutional sources of finance continues to be evident in poorer households.

Banks need to develop a culture of Socially Responsible Investing (SRI).

The focus of financial inclusion in India has progressed from ensuring bare minimum access to a no-frills savings bank account for the unbanked population to the concept of 'Total Financial Inclusion'. Increased involvement of commercial banks in micro-financing is essential for a

sustainable micro-financing programme in the country. The prevalence of moneylenders in the rural financial sector continues to be significant.

Exploitation of the synergies between local financial institutions and national-level financial entities would help achieve greater financial inclusion. Financial inclusion can be enhanced through the introduction of products tailored to the needs of small borrowers. IT-enabled banking services have the potential to effectively meet the challenge of reaching out to financially excluded customers, especially in rural areas. Another option is to suitably incentivise business correspondents (BCs) to popularise the process after looking at it from a holistic perspective, taking into account both risk and returns in the interests of its long-term viability.

Mobile banking services have the potential to significantly lower transaction costs, while expanding outreach to rural areas. However, key challenges in developing a mobile banking system include the lack of standardisation and the security aspects of financial transactions being executed through mobile telephony. KYC norms could be diluted further to provide banking services to the urban poor. Household and consumption expenditure would also need to be financed by banks to avoid non-institutional sources of borrowing.

There is a requirement to grant operational flexibility to banks to fix interest rates, reduce costs, enhance their risk assessment capabilities and permit better flow of credit information to credit information bureaus.

Though the Government and the Reserve Bank have taken several initiatives to bring the unprivileged and weaker sections of society within the banking fold, given the magnitude of financial exclusion within the country, further efforts are required.

Despite their dominant numbers and importance in job creation, SSIs have traditionally faced difficulty in obtaining formal credit or equity. Lending institutions must improve their ability to provide financial services to SSIs through commercial mechanisms that lower costs and minimise their risk exposure.

Offering customised solutions to diverse customer groups remains a challenge in India. Limited awareness of customer rights and changing customer expectations also present a difficult task for banks. While there is a need for banks to develop customer databases so that they can tailor products and services in line with customer needs, the risks associated with

maintaining the confidentiality of such data need to be addressed through proper control mechanisms.

As long as the basic principles for treating customers fairly like transparency, reasonableness, integrity in selling, confidentiality, assistance when needed and an effective grievance redressal machinery are being followed, whether a statutory or self-regulatory route is followed is not material to achieving the desired objectives.

Sustainable development of the financial sector is a key element for risk assessment. Banks need to develop a culture of Socially Responsible Investing (SRI) as a motivation to enhance their sustainability disclosure standards.

## 7.7 Concluding Observations

In the current socio-economic milieu, social priorities in financial policies are important for financial stability since a well-functioning financial system can help reduce poverty through inclusiveness. Since a free market by itself has some limitations in achieving social objectives, policy intervention from the Government and regulators becomes necessary. In this context, the Advisory Panel on Financial Stability and Stress Testing has rightly addressed specific issues pertaining to financial inclusion, customer service and access to SSIs, and made certain recommendations including the exploitation of new technology and new business models and linkages.

Besides the specific comments made, the CFSA is in broad agreement with the analysis and recommendations of the Advisory Panel. Mr. V. Sundararajan, peer reviewer, has also expressed broad agreement with the Panel's findings and recommendations. Mr. Andrew Sheng, in his peer review, observes that the development issues deal with social stability (fairness and equity), rather than financial stability. According to him there is strictly no contradiction between the two as the former reinforces the latter. These are issues faced by emerging economies and are social objectives. The only danger is that the social stability policies could be at the expense of financial stability in terms of erosion of capital or proper risk management. According to him, access to finance and information would require investment in social infrastructure that should be tackled fiscally rather than relying totally on private sector initiatives. Reducing the social cost of evaluating SSI credit could be a way of levelling the playing field with evaluating cost of loans to large credits.

While the CFSA appreciates the spirit of Mr. Andrew Sheng's observations, in the Indian context where social priorities have conventionally been recognised as a part of financial policies, the present approach to inclusive policies would serve the Indian democratic polity better. The CFSA hastens to add that such prioritisation is in no way at the cost of financial stability in terms of prudential and risk management policies.

# Chapter VIII

# Summary

## 8.1 Macroeconomic Environment

As macroeconomic developments and shocks have an impact on the financial sector, the role of macro-prudential or financial stability analysis has gained in importance in recent years among central banks, regulatory authorities and international agencies. Hence an assessment of the financial sector needs to recognise the linkages between macroeconomic performance and financial stability.

The Indian financial sector in terms of institutions, markets and infrastructure has expanded and acquired greater depth and vibrancy particularly after the reforms since the early 1990s. However, in view of the current turmoil in financial markets, the overall assessment of the global economic trends as also the related issues in the Indian context had to undergo a shift from a benign and optimistic outlook to a relatively more cautious one and guarded against many downside risks, though the overall optimism has not been completely lost, at least in the Indian context. In this turbulent environment, many of the mainstream ideas about central bank independence, single objective, Lender of Last Resort (LoLR), and separation of regulation and supervision are coming under renewed discussion. The CFSA has followed these trends and approached related issues with considerable nuance in the institutional and country context.

(Section 2.1)

After stronger than expected growth till the third quarter of 2007, most of the advanced economies recorded a sharp deceleration in their growth towards the end of the year, driven mainly by the global financial crisis, which spread beyond the US sub-prime mortgage market to other jurisdictions. The overall balance of risks to the short-term global growth outlook, thus, remains heavily tilted to the downside. Financial risks remain elevated, as rising losses in the context of a global slowdown could add to strains on capital and exacerbate the squeeze on credit availability. However, inflation is a declining concern.

## Chapter VIII

## Summary

Global financial markets which witnessed heightened uncertain conditions during the first half of 2008, has deepened further and entered a new turbulent phase in September 2008, which has severely affected confidence in global financial institutions and markets. Slowdown has been witnessed in both advanced as well as emerging market economies like Argentina, China, India, Malaysia and Thailand during the second quarter of 2008. The IMF has recently revised its estimate of loss due to the sub-prime crisis to USD 1.3 trillion.

(Section 2.2)

The performance of the Indian economy has been impressive with real GDP growth, accompanied by a decline in population growth and associated with consistent trends of increasing domestic savings and investment over the past two decades. Besides a consistent upward trend in India's investment rate, there is evidence that capital has been employed productively. Domestic demand has been the main driver of economic activity. While inflation rates were benign for most of the current decade in tune with global trends, there was a spurt in inflation in early 2008 followed by a sharp decline in recent months due to the cooling of energy, commodity and food prices. However, the reversal of capital flows which have led to liquidity shortage in the economy has made the Reserve Bank reduce the Cash Reserve Ratio and the repo rate to 5.0 per cent and the reverse repo rate to 3.5 per cent . There has also been a reduction in SLR from 25 per cent to 24 per cent. Indicators on financial soundness, including stress tests of credit and interest rate risks, nevertheless suggest that banks continue to remain healthy and robust.

Since 2003-04, there has also been a significant jump in bank credit growth. Merchandise exports are growing and becoming increasingly broad-based in terms of destinations and composition, reflecting India's growing integration into the global economy. Despite the widening trade deficit, the current account deficit has remained modest, due largely to high levels of private transfers and increasing service sector exports. Strong capital inflows have been instrumental in financing the current account deficit. The global financial turmoil has, however, led to a reversal in trend in respect of both trade and capital flows in 2008-09 which has impacted the capital market and foreign exchange markets significantly. The foreign exchange reserves which were USD 309.7 billion at end-March 2008 have declined and stood at USD 249.3 billion as on February 27, 2009.

During 2008-09, the rupee witnessed highly volatile conditions which have particularly accentuated from mid-September, 2008. Financial markets in India in general have gained in depth, liquidity and resilience, with foreign exchange market and derivative transactions volumes in India exhibiting the fastest growth among the countries surveyed by the BIS. Though there has been improvement in all the deficit indicators, emerging fiscal pressures point to the need for continued focus on fiscal balance.

The fiscal position of the Government since 2004-05 has been influenced by the rule-based fiscal correction process that is based on the Fiscal Responsibility and Budget Management (FRBM) Act implemented by the Central Government in July 2004. However, given the current pressures on the economy in terms of oil price volatility, declared farm loan waivers coupled with various fiscal stimulus measures keeping in mind the global financial crisis that have been offered to keep the country on a high growth trajectory, it was not possible to contain the fiscal deficit at budgetary levels for the year 2008-09. The Government has in fact, deviated from its fiscal reform path and the FRBM targets have been relaxed to allow for higher spending as well as to absorb the impact of lower revenue growth expected in 2008-09 and 2009-10. The Government has announced that it will return to FRBM targets, once the economy is restored to its recent trend growth path.

(Section 2.3)

While there would be some moderation in the rates of growth in the immediate future due to uncertain global market conditions, it is felt that India would return to its trend eight percent plus growth rate over the medium term as economic normalcy returns to the global economy. The growth process seems sustainable in view of various growth enabling factors: (a) growth is led by demand – both of investment and consumption; (b) favourable investment climate; (c) continued general increase in capital goods production; and (d) rise in sales and profits in the corporate sector. Further, Indian economic growth has been largely enabled by a sustained increase in the level of domestic savings.

The low debt to equity ratio points to higher internal accrual and buoyancy in the capital market. However, the question is the sustenance of the low debt to equity ratio. Recent times have also seen a sharp correction in the valuations of listed firms; to that extent, there could be some reversal in the declining debt to equity ratio.

Going forward, there is a need to achieve an improved balance between financial development and financial stability. Also, for the growth momentum to be sustained, it will be necessary to ensure fiscal prudence at both the central and State Government levels. The key to maintaining high growth with reasonable price stability lies in rapid capacity additions through investments, productivity improvements, removal of infrastructure bottlenecks and amelioration of skill shortages.

(Section 2.4.1)

In the present phase of growth momentum as witnessed in the service and industrial sectors, the agricultural sector needs to grow faster than its long-term average growth rate of 2.5 per cent. There is a need for improving both the forward and backward linkages through better credit delivery, investment in irrigation and rural infrastructure, improved cropping patterns and farming techniques and development of the food processing industry and cold storage chains across the entire distribution system.

(Section 2.4.2)

Given the recent increase in international food, energy and commodity prices (which have moderated considerably of late), placing additional pressures on food- and energy-related subsidies, the declared farm loan waivers, and the implementation of Sixth Pay Commission recommendations, it was not possible to contain the fiscal deficit at budgetary levels for the year 2008-09. This could impact private sector investments, going forward.

(Section 2.4.3)

The critical constraint to economic growth in India in recent years has been the infrastructure deficit. An investment requirement of roughly Rs. 22,50,000 crore has been projected as financing requirements for physical infrastructure (comprising roads, power, telecom, railways, airports and ports). The emphasis has shifted towards public private partnerships (PPPs). Sustained growth in private sector infrastructure investment can take place in only those sectors which are financially viable and exhibit adequate returns. It is perceived that commercial entities such as banks could play an important role in financing infrastructure projects. There are, however, issues of asset-liability mismatch in respect of bank finance. Non-banking Financial Companies' (NBFCs) lending will have higher cost implications. Exposure limits to large developers, managing external commercial borrowing in keeping with resulting macroeconomic vulnerabilities and desirable levels of capital flows are other imperatives in this regard. In this context, therefore, there is a need to shift from the bank-dominated financing system to a market-based system for financing infrastructure and housing projects, which would depend upon the development of an active corporate bond market. This would call for pension reforms and allowing pension and insurance companies to invest more in long-term corporate debt.

(Section 2.4.4)

The huge availability of the labour force in India creates a potential for additional growth, provided that productivity-led growth is sustained. The

challenge going forward will be to create jobs on a scale needed to successfully absorb excess agricultural labour and the rapid increase in the labour force over the next few decades.

(Section 2.4.5)

The pass-through of international oil prices to domestic inflation is somewhat constrained because of the Government's policy of price controls and cross subsidies. Apart from inflationary pressures, any rise in international oil prices would have potential implications for the current account deficit and the exchange rate. If domestic prices are not raised commensurately, the rise in international crude prices would adversely affect the financial performance of domestic oil companies. This may necessitate further financial support to the oil companies from the Government, which would cause a strain on government finances. However, adjustment in domestic oil prices to changes in international prices needs to consider the volatility aspects, distinguishing long-term trends from temporary spikes. With high exposure to oil imports, combined with its widespread impact on the domestic economy, a more efficient use of oil products would be warranted, such as thoroughly improved public transportation systems.

(Section 2.4.6)

Besides the oil price rise, another recent major concern both domestically and globally was the rise in food prices. However, some abatement of global prices, indication of better domestic supplies and addition to buffer stocks, along with the series of measures already taken by the Government on the supply side, are expected to yield results in the months to come.

(Section 2.4.7)

With the gradual opening of the economy, the foreign investment flows into India, comprising foreign direct investment (FDI) and foreign portfolio investment (FPI), have risen sharply. However, consequent to the global financial crisis there has been a reversal of capital flows and, based on the duration of the crisis, India may continue to face further net outflows. While the capital inflows eased the external financial constraint, they have posed dilemmas for the conduct of monetary policy. India's approach in regard to the capital account has consistently made a distinction between debt and equity, with greater preference for liberalisation of equity markets *vis-à-vis* debt markets. There appears to be a broad consensus that CAL is desirable, but should be gradual, well sequenced and undertaken in conjunction with several other measures at the micro and macro level.

(Section 2.4.8)

The resilience of the financial system can be tested by subjecting the system to stress scenarios which are reflective of system resilience to one-time shocks. However, in India, stress testing scenarios often tend to be hypothetical due to a lack of past data on benchmarks and constraints on data

availability which hinder the building of an appropriate and comprehensive macroeconomic model.

(Section 2.5)

India is placed 31st (out of 52 countries) in terms of its overall ranking on the Financial Development Index 2008. As per the Index, while India delivered solid results in terms of its financial markets (particularly foreign exchange and derivatives) and its non-bank institutions, its banks appeared hamstrung by lack of size, low efficiency and poor information disclosure. Despite this, the banking system has been considered very stable (ranked 5th), owing in part to sizable capital buffers that help it weather credit cycles.

(Section 2.6)

## 8.2 Institutions

Commercial banks are the dominant institutions in the Indian financial landscape, accounting for around 60 per cent of its total assets. Together with co-operative banks, the banking sector accounts for nearly 70 per cent of the total assets of Indian financial institutions. The insurance sector, the second largest group of institutions, has also been opened up to private competition in recent years. The growth rate of NBFCs and mutual funds is robust.

The assessment of the institutions has been carried out both from the stability perspective as also the perspective of adherence to international standards and codes.

The present sub-prime crisis has highlighted the limitations of the present Basel Core Principles inasmuch as it does not specifically cover areas like SPVs/NBFCs or aspects like dynamic provisioning and countercyclical norms as part of the assessment. Hence, the CFSA feels that Basel Committee on Banking Supervision needs to revisit the Basel Core Principles to cover the new areas.

(Section 3.1)

### 8.2.1 Commercial Banks

*Performance and Related Issues*

Commercial banks continue to show a healthy growth rate and exhibit an overall improvement in areas of capital adequacy, asset quality, earnings and efficiency indicators. Deposits continued to be the main source of funding. The large increase in deposit and credit has led to significant financial deepening. The Indian commercial banking system also exhibited an

increasing degree of solvency as measured by the Z-score. The increasing exposure of the banks in the derivatives segment has raised issues relating to customer appropriateness and product suitability. Coupled with this is the need for better understanding of off-balance sheet liabilities of banks and better systems of accounting and disclosures along with a centralised netting, collateral custody and clearing system.

(Section 3.2.11, 3.2.12)

Despite increase in competition in the banking space, PSBs continue to dominate the commercial banking arena. The new generation private banks are emerging at very fast pace within the commercial banking sector, which contradicts the assumption that branch licensing policy is stifling their growth. Though efficiency as measured in terms of business per employee ratio is lower for public sector banks and old private sector banks, their cost-income ratio shows a significant degree of convergence with other bank groups. Capital adequacy ratios across bank groups have remained above regulatory minimum and NPA ratios have shown a decline. The asset quality of banks has shown improvement inasmuch as there has been a decline in asset slippage ratio and an increase in coverage ratio. The return on assets of scheduled commercial banks had shown improvement over years and return on equity continued to hover around 15 per cent for scheduled commercial banks. The cost-income ratio of scheduled commercial banks had also shown improvement. The treasury income which was second most important source of income till 2003-04 has declined to negligible levels due to upturn in interest rate cycle. Higher net interest income and fee income coupled with lower operating costs have helped banks make significant improvement in profits in recent years. The OBS exposure has also seen a spurt mainly on account of an increase in derivatives.

(Section 3.2.12)

The global financial turmoil has had repercussions in the Indian financial markets, particularly in the equity and foreign exchange segments. The banking sector however has not been impacted significantly as is evident from its comfortable capital adequacy, asset quality and profitability indicators for the half year ended September 2008 and for the quarter ended December 2008.

(Section 3.2.13)

The banking sector is predominantly government-owned with PSBs accounting for more than 70 per cent of the assets. The ownership in public sector banks is now well-diversified. Contrary to the general perception that PSBs are monoliths, they compete not only with each other but also with private and foreign banks. One member, however, was of the opinion that 70 per cent of the assets of commercial banks being held by the public sector banks, where Government is the majority shareholder, could affect competition.

While government ownership of banks augurs well for systemic stability, it is argued that there could be adverse consequences inasmuch as

there is a possibility of regulatory forbearance that might lead to larger fiscal costs in the medium term. In the Indian context, however, it is observed that the cost of recapitalisation of PSBs has been relatively low.

In this context, the relevance of privatisation of PSBs, on the grounds of promoting competition and strengthening financial performance, coupled with further liberalisation measures like freedom for foreign investment and entry of foreign banks in the banking sector needs to be deliberated upon in detail. As the ultimate goal of any such exercise should be to make the commercial banking system efficient in mobilisation of savings and as purveyors of credit, there is a need to take a nuanced and more pragmatic view on this issue on several considerations.

There is no conflict of interest in Government's role as owner of banks and its relationship with the regulator. The Reserve Bank is an independent regulator and neither its powers to regulate PSBs decrease nor is any regulatory forbearance exhibited by it towards these banks because of government ownership. The same set of regulations are applicable to all banks, irrespective of their ownership, across the board.

Given the projected growth rate of economy at 8 per cent in the medium term, PSBs would need additional capital to maintain the momentum of credit growth required to fund real economic activity**.** Recently the Government has demonstrated that the growth of PSBs need not necessarily be constrained for want of adequate capital. However, if the Government does not want to bring its holdings below 51 per cent, it would be required to make larger contributions going forward, with resultant fiscal implications. The amalgamation of banks including PSBs should be done keeping in view the synergies, complementarities and the regional spread of the banks proposed to be amalgamated. For those PSBs which are on the borderline of minimum government share holding, one option could be that they are amalgamated with other PSBs where government holding is considerably higher than the stipulated minimum of 51 per cent. This, however, should be done only if there are synergies to be exploited through such amalgamations.

While the CFSA notes that PSBs do have managerial autonomy on issues like technology upgrading and lateral recruitment of specialists, it feels that if the Government ceases to be the majority shareholder, the PSBs would be in a better position to attract talent in large numbers as they would not be constrained by government pay structure. This would further facilitate

technology upgrading and lateral recruitment of specialists with appropriate skill sets in larger numbers. Once the process of reducing government shareholding to below 51 per cent in select public sector banks is begun, such banks would be able to operate in ways similar to the new private sector banks. However, dilution in stake should be subject to wider holding by private shareholders, all members of the board being subject to fit and proper criteria, and these banks being subject to the same responsibilities and continuing to undertake the government's agency functions.

There is need to further strengthen old private sector banks and the Reserve Bank needs to create a conducive environment to enable primarily market-driven amalgamation of these entities.

The roadmap for foreign banks is proposed to be reviewed in March 2009, and the Government and the Reserve Bank need to consider certain issues at the time of review, viz., foreign banks to enter either through subsidiary or branch route; branch licensing policy could be broadly structured on the lines followed in case of new private sector banks consistent with country's WTO commitments but subject to reciprocity; in the case of the subsidiary route; the foreign shareholding should not exceed 74 per cent; these banks should be listed on the stock exchange; the need to have independent board members for subsidiaries; their entry should not result in lower flow of credit to SMEs; and subsidiaries should be subject to all requirements that Indian banks are subject to.

In Indian context, there is a proposal to remove ceiling on voting rights in respect of private sector banks which is awaiting nod of the Parliament. While there is merit in allowing voting rights to be proportionate to shareholding, any shareholding in excess of the threshold 10 per cent could continue to need prior approval of the Reserve Bank. These are consistent with practices followed in advanced financial markets.

(Section 3.2.41)

Corporate governance principles could essentially be the same across bank groups. The requirement of professional directors is applicable across banking sector, however, to improve governance in PSBs, there could be requirement of ensuring proper quality of directors by adhering to the fit and proper criteria both in letter and spirit and improving flexibility in decision making, unhindered by government interference. The constructive intervention of the Government in critical areas such as agriculture and SMEs may be necessary to fulfil the objectives of more inclusive growth.

Though the scope of influence of external agencies like CVC over the years has undergone a change and the existing arrangement has worked well, in case the Government remains majority shareholder of commercial banks, there is still a need to redefine the scope of work of these agencies. There may be a requirement to come out with a separate CVC manual in this regard.

The aspect relating to members of the board having substantial interest defined on the basis of ownership exceeding Rs.5 lakh or 10 per cent of paid-

up capital of the company, whichever is less, needs to be reviewed by removing the quantitative ceiling of Rs.5 lakh and stipulating an appropriate share of paid-up capital. There is need for a stipulation similar in spirit to Clause 49 of Listing Agreement which prescribes that one-third or one-half of the board members need to be independent directors for unlisted banks.

(Section 3.2.42)

Given the overall improvement in performance of banks, none of the banks are presently hitting the PCA trigger. As the aim of supervision when putting a supervised entity under PCA would be to nurture it back to health, any rigidity in fixing timeline could prove unduly to be restrictive. As regards disclosure of the names of banks that hit PCA triggers, given the systemic implications in the event of any bank hitting the PCA trigger, the disclosure of the bank's name could be considered by BFS at a later stage. The Reserve Bank needs to widen the scheme of PCA to cover co-operative banks and systemically important NBFCs. Likewise, SEBI and IRDA need to devise a scheme for mutual funds and insurance companies, respectively.

(Section 3.2.45)

Consolidation has both advantages and disadvantages and a holistic view needs to be taken. While Indian banks' ability to fund large loan requirements hinges on their having a 'critical size', consolidation could lead to greater concentration which poses systemic risks. An enabling market-driven environment needs to be created for market-driven amalgamations.

Given the provisions of Competition Act, the Reserve Bank may be able to consider giving sanction to the scheme of amalgamation only after giving notice to Commission and waiting for a maximum period of 210 days, which would delay the whole process and could raise issues relating to regulatory conflicts. There is a need for the Central Government to exempt the banks from the provisions of Section 54 of the Competition Act (The issue has already been taken up by the Government).

(Section 3.2.46)

Given the fact that banks have historically been subject to different legislations as also the fact that the Government has at various points of time tried to come out with a single banking legislation for PSBs, single banking legislation for all PSBs could be a first step forward and the Government could consider subjecting all commercial banks to a single legislation over the medium term.

(Section 3.2.47)

There is a requirement for upward revision of the remuneration/ incentive structure of PSBs commensurate with responsibility and to be more in alignment with the changing times. The recent crisis has also highlighted the role of managerial remuneration in the financial sector which leads to excessive risk taking and adverse selection problems. There is a need to ensure that the incentives for top management and key executives are monitored and linked to their performance over a longer-term economic cycle.

(Section 3.2.48)

*Stress Testing and Risk Management*

The stress tests have revealed that the banking system can withstand significant shocks due to changes in credit quality, interest rate and liquidity conditions.

The present assessment of resilience was limited to single factor sensitivity analysis given the lack of data to link macroeconomic scenarios with financial soundness indicators and also the lack of any 'stress events' in the Indian financial system for the past fifteen years. However, there is a need to develop a set of vulnerability indicators to facilitate model building for early warning signals by linking the stress tests with appropriate macroeconomic scenarios. An inter-disciplinary Financial Stability Unit, which could periodically monitor systemic vulnerabilities, is required to be set up.

(Section 3.2.2)

There is a need for centralisation and integration of all risks in order to monitor and mitigate embedded risks. Estimation of economic capital to help facilitate adoption of RAROC methodology could be a way forward. The Reserve Bank needs to look into aspects relating to dynamic provisioning in detail.

The Reserve Bank has issued guidelines on ICAAP as part of the supervisory review process under Pillar II of Basel II, which is currently applicable to banks with overseas operations and foreign banks and would be extended to all other banks from March 31, 2009.

The Reserve Bank has put in place regulatory guidelines covering many of the recommendations given by Financial Stability Forum in April, 2008 to enhance the resilience of markets and financial institutions, while, in regard to others, actions are being initiated.

The on-site examination of banks as part of the supervisory process should be supplemented by a forensic 'follow the evolution of product' approach, whereby the evolution of a derivative product is followed through its origination to final holder to check whether the financial institutions, infrastructure and trading, clearing and settlement, and risk management processes along trading chain are adequate with sufficient due diligence and risk controls/audit trail.

(Section 3.2.44)

*Credit Risk*

The stress testing of credit risk has revealed that even in the worst-case scenario (assuming an increase in NPAs by 150 per cent), the CRAR would remain well above the regulatory minimum, implying that the effects of stress on the credit portfolio of banks remains relatively muted. Though credit risk concerns remain low at present, there is a need to continuously and closely monitor such risks in order to avoid any unforeseen events of significant asset quality deterioration over the medium term.

(Section 3.2.21)

Internationally, the rapid global credit growth observed till 2007 was more pronounced in the retail sector and led to an increase in lending to riskier borrowers. Supervisors did not react to the situation through issuance of countercyclical prudential norms. However, in the Indian context, the Reserve Bank had cautioned banks on the need for proper risk assessments and honing of risk assessment skills. Risk weights for retail, real estate and capital market exposures had been enhanced as countercyclical measures. Provisions for standard advances on exposures to these sectors had also been increased, which would help to cushion the negative fallout of a cyclical downtrend. These measures have yielded results inasmuch as the impact of the sub-prime turmoil in India has been relatively subdued. With moderation in economic growth and need to provide impetus to certain sectors through a credit push saw a reversal of measures in November 2008.

Given the recent marginal increase in NPAs in the retail sector, there is a need to hone credit assessment skills in retail loan administration. The importance of credit derivatives as a hedging tool is important for the banking sector. However, the recent incidents in the international markets have highlighted the need to adopt a gradualist approach by sequencing the reforms and putting in place additional safeguards while adapting credit derivatives to the Indian situation.

Though the sharp growth in credit witnessed by the Indian banking sector from financial year 2004-05 onwards has been devoid of much concentration risk, it has also seen growth in sub-BPLR loans. Despite the increase in sub-BPLR loans, there has been no deterioration in pricing and interest margin of banks. This raises concerns about the computation of sub-BPLR if the banks are able to lend at sub-BPLR and also maintain the same interest margins.

The recent period has also seen an increase in dependence on bulk deposits to fund credit growth, which could have liquidity and profitability

implications. An increase in growth in real estate exposure as also the infrastructure sector as evidenced during this period has resulted in elongation of maturity profile of the bank assets. Simultaneously, there has been a shortening of the residual maturity of liabilities, leading to a higher asset-liability mismatch.

Given some increase in delinquency noticed in the retail portfolio, there is a concern that the high level of retail borrowings by households in recent past could, in the event of a downturn in conjunction with the prevalent trend of increasing interest rates, impair repayment schedules and increase their indebtedness. Also, the lack of availability of relatively recent data on household indebtedness is a concern, particularly in view of the increase in the retail loan portfolio of banks in recent years and the possibility of a default on such loans.

(Section 3.2.43)

*Market Risk*

The stress test of interest rate risk reveals that the duration of equity of commercial banks has reduced from 12.0 years in 2007 to 8.0 years in 2008 – a pointer to better management of interest rate risk by banks.

(Section 3.2.22)

Banks have been actively managing their interest rate risk by reducing the duration of their assets. The exposure of banks to capital market remains low and direct equity exposure is small; hence, any adverse movement of this market has a limited impact on banks.

As regards capital market exposure, limits can be fixed bank-wise on a case-by-case basis depending on the individual bank's risk profile and risk mitigating capabilities.

(Section 3.2.44)

*Liquidity Risk*

The analysis of a set of liquidity ratios reveals that there is a growing dependence on purchased liquidity and also an increase in the illiquid component in banks' balance sheets with greater reliance on volatile liabilities to fund asset growth. There is a need to shore the core deposit base and keep an adequate cushion of liquid assets to meet unforeseen contingencies. Scenario analyses of liquidity stress carried out for the five largest banks show that, under the most stringent assumptions, except in one case where there is marginal shortfall in respect of one bank, these banks generally have sufficient liquid assets to withstand deposit withdrawals for at least one day in the event of loss of depositors' confidence.

(Section 3.2.23)

It may be worthwhile considering specific regulatory capital charge if a bank's dependence on purchased liquidity exceeds a defined threshold.

The Reserve Bank needs to consider for Indian banks the scope, applicability and implementation of the 'Principles for Sound Liquidity Risk Management and Supervision' recently issued by BCBS.

There is a need for the Reserve Bank as well as banks that have systemic linkages to carry out periodic scenario testing to assess resilience to liquidity shocks; this could then be extended to other banks. Also, assessment of liquidity risk, which is part of the individual bank's internal capital adequacy assessments (ICAAP), should be supported by appropriate stress and scenario testing arising out of liquidity shocks. These can be supplemented by system-wide modelling of liquidity by using different levels of margins and risk spreads to ensure that the macro-prudential supervisor is able to identify where liquidity pressures may build up in the system as a whole, rather than in specific institutions. Also, implementation of contagion risk management techniques which would explicitly take into account the impact of other risks on liquidity risk, should be undertaken in a phased manner.

There is a need for capacity building in the context of effective management of liquidity risk. The guidelines on liquidity risk should cover foreign exchange exposure of banks.

(Section 3.2.44)

*Operational Risk Management*

Though the Reserve Bank has issued guidelines to its inspecting officials whereby they should comment on implementation of policies to address operational risk, a mechanism needs to be put in place whereby the banks should be required to report to the Reserve Bank any developments affecting operational risk in the banks.

(Section 3.2.44)

*Stress Testing – An Update*

An updated stress test done on banks in respect of credit risk for end-September 2008 reveals that the impact of potential deterioration in asset quality remains reasonably muted. In the case of interest rate risk, the stress test reveals that banks are not at very significant risk from rise in interest rates. Likewise, the effect of the stress test on equity price risk on the CRAR of banks is not significant. An analysis of the stress test on liquidity risk reveals that there has not been much change from the March 2008 position; however, there is a need to pursue a more effective policy for liquidity risk management.

(Section 3.2.24)

*Assessment of Basel Core Principles*

The assessment of the 25 Basel Core Principles has revealed that seven principles are compliant, 11 are largely compliant, six are materially non-

compliant and one is non-compliant. The non-compliance was related to interest rate risk in the banking book, where there were no guidelines at the time of assessment. The CFSA notes that the Reserve Bank has since issued guidelines on supervisory review process which contains, *inter alia,* guidelines on interest rate risk in the banking book. The assessment had revealed that the responsibilities and objectives of the supervisory authority are clearly defined. A suitable legal framework is also in place. The licensing criteria and permissible activities that can be undertaken by a bank are clearly defined. Detailed guidelines on capital adequacy covering both on- and off-balance sheet items have been issued to banks. The Reserve Bank has issued detailed guidelines on credit risk, market risk, country risk and operational risk. It has also issued detailed guidelines on Know Your Customer (KYC) and Anti-Money Laundering (AML) concerns. The Reserve Bank has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. However, the assessment had revealed that there are gaps in areas of risk management process, exposure to related parties, market risk, liquidity risk, interest rate risk in the banking book, supervisory approach and home-host country co-operation. Some of the major recommendations to fill the gaps are:

i) While the Reserve Bank enjoys independence vis-à-vis the executive arm of the State, the Central Government has powers to remove the Governor of the Reserve Bank without specifying any reasons and without publicly disclosing the reasons for removal of the head of supervisory authority. Considering the Reserve Bank's success as a regulator amidst its diverse activities and also that by convention the Reserve Bank's independence is fairly well established, at this stage there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/ Deputy Governor could be removed.

ii) The Reserve Bank is subject to direct examination by standing committees of Parliament and is hence fully accountable to Parliament. Hence the current framework of indirect accountability of the Reserve Bank to Parliament through the Ministry of Finance is adequate.

iii) The guidelines on credit risk should include credit risk arising from various financial instruments and the ALM guidelines on liquidity risk need to cover foreign currency exposures of the banks.

iv) Given the diverse risk management techniques across the banking sector, the implementation of contagion risk techniques as regards liquidity risk could be undertaken in a phased manner.

v) There is a need for capacity building in respect of both banks and the Reserve Bank, before banks embark on advanced models of credit and operational risk.

vi) The Reserve Bank has issued detailed guidelines on income recognition and asset provisioning. As per extant guidelines, provisioning is not

done on an individual basis for the sub-standard category of NPAs. Keeping in view the cost of compliance, the present stipulations could continue for the present. However, considering the very large number of low-value NPAs which are substandard, if at all provisioning has to be done individual account-wise, a cut-off level should be set above which all accounts can be provided for individually. This cut-off level may be lowered in a phased manner.

viii) The Reserve Bank issued guidelines regarding fit-and-proper criteria for directors of private sector banks and elected directors of nationalised banks and the State Bank of India (SBI) and its associates. These guidelines require banks to undertake the test at the time of their appointment and renewal to the board. Further, banks are required to give a yearly undertaking that the information already provided by them has not undergone any change and, where there is any change, requisite details are to be furnished by the directors forthwith. However, there is no requirement for the banks to notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a board member or a member of the senior management. The Reserve Bank may issue specific guidelines that mandate banks to notify the Reserve Bank as soon as they become aware of any material information which may negatively affect the fitness and propriety of a board member or a member of the senior management.

ix) Though the Reserve Bank has issued guidelines from time to time on the segregation of duties and responsibilities in the front office, middle office and back office for treasury operations, it is not being determined whether there is an appropriate balance of skills and resources in the back office and control functions relative to the front office. The Reserve Bank may issue appropriate guidelines to banks stressing the maintenance of such a balance by banks. The on-site inspection manual should incorporate a suitable provision mandating on-site inspectors to specifically comment on this aspect in their reports.

x) The passage of BR Act (Amendment) Bill, 2005 which deals with the insertion of Section 29(A) would empower the Reserve Bank to conduct consolidated supervision. The present global financial crisis has highlighted the importance of cross-border co-operation. G-20 has, in its recent meeting, highlighted the importance of cross-border co-operation. Until a global agreement is reached in this regard, there is a

need to examine the pros and cons of entering into MoUs with foreign regulators as regards home-host country relationships.

(Section 3.2.3)

**8.2.2 Co-operative and Rural Banking**

The size of the co-operative and the rural financial sector in India remains small compared to commercial banks. The financial performance of the co-operative sector is less than satisfactory in certain aspects.

Dual control in the co-operative sectors affects the quality of supervision and regulation between the Reserve Bank/ NABARD and the Government. The problem has been ameliorated to a great extent through MoUs. There is, however, a need to examine the structure of the MOUs in greater detail to include in a more granular manner further issues of regulatory co-operation particularly in areas related to governance and management. The format of the MoU could be fine-tuned based on the requirements of individual State Governments/Central Government, with selective deviations that suit the requirements of individual states/ institutions without diluting the sound principles of the uniform format.

(Section 3.3.11)

In the case of rural financial institutions (rural co-operatives and RRBs), banking regulation is vested with the Reserve Bank while supervisory powers, which are limited, lie with NABARD. Though there is a view that the present arrangement, wherein NABARD and the Reserve Bank both have well-defined roles in terms of the RBI Act, 1934 and RRBs Act, 1976, need not be disturbed now, the role of NABARD as a DFI and regulator/supervisor of rural financial institutions may be considered to be segregated appropriately so that NABARD will exclusively function as a specialised DFI with regulation and supervision of RRBs vested with the Reserve Bank. The Government is of the opinion that the present arrangement need not be disturbed. As regards supervision of rural co-operatives, a separate regulatory and supervisory authority could be formed. The new body may need to function in close co-ordination with Reserve Bank.

(Section 3.3.12)

Borrowers have a significant say in the management of a co-operative bank. As a result, the impairment in corporate governance and management needs of co-operatives is not ruled out, given the tendency by these entities to pursue borrower-oriented policies. Further, the appointment of directors is on the basis of political affiliations rather than on merit. Hence, there is a requirement to encourage membership of depositors on par with borrowers and reduce political interference in order to improve the functioning of these entities.

Powers regarding appointment of auditors, simplification of the tiered structures of rural co-operatives to reduce costs, and bringing aspects related to the management of co-operative banks within the ambit of BR Act could be considered. The best governance principles as enunciated by the World

Council of Credit Unions could be considered for introducing greater professionalism and as a best practices guide for corporate governance.

(Section 3.3.13)

Capital adequacy norms need to be strengthened by prescribing duration-based capital charge for market risk for scheduled UCBs. The risk-based capital requirement for rural financial institutions could be introduced only after completing recapitalisation of these banks after their consolidation.

(Section 3.3.14)

There is a need to draw up roadmap whereby banks which fail to obtain a licence by 2012 would not be allowed to operate. This would expedite the process of consolidation and weeding out of non-viable entities from the co-operative space.

(Section 3.3.15)

*Urban Co-operative Banks*

The performance of UCBs has shown improvement with the number of financially stronger UCBs increasing between 2004-05 and 2007-08. Deposits continue to be their dominant funding source. The capital adequacy position, despite some decline, continues to be comfortable. The asset impairment ratios, though high compared to commercial banks, have shown improvement. There is a need to pursue consolidation in the sector in a non-disruptive manner.

(Section 3.3.21)

Stress tests conducted on the credit portfolio for scheduled UCBs show that the resilience of the sector to adverse movements in credit quality is not very strong.

(Section 3.3.22)

The assessment of Basel Core Principles reveals that four principles are compliant, 11 are largely compliant, four are materially non-compliant and two are non-compliant while four principles are not applicable to UCBs. It reveals that there are gaps in areas of risk management, internal control, abuse of financial services and disclosure in balance sheet. Some of the recommendations to fill the gaps are as under:

(i) The Reserve Bank needs to revise ALM guidelines on structural liquidity issued to larger scheduled UCBs to take into account undrawn commitments and off-balance sheet items.

(ii) There is no need for prescribing capital charge for operational risk for UCBs; however, basic guidelines on operational risk could be issued to larger UCBs.

(iii) It would be premature to issue guidelines on interest rate risk in banking book to the UCBs.

(iv) Guidelines need to be issued whereby UCBs should notify the Reserve Bank/Registrar of Co-operative Societies as soon as they become aware of any material information which affects fitness and propriety of a board member or any member of senior management.

(v) The Reserve Bank should issue guidelines to larger UCBs on segregation of duties and responsibilities in the front office, mid office and back office for treasury operations and the on-site inspection by Reserve Bank should also comment on the same.

(vi) The Reserve Bank, in consultation with State Governments and ICAI, should explore the possibility of making it mandatory for external auditors to notify the Reserve Bank of any external development that comes to their notice during the course of audit.

(vii) Appropriate guidelines need to be issued whereby the bank's staff gets protection for reporting in good faith, either internally or directly, to the relevant supervisory authority about any suspicious activity.

(viii) There is a need for enhancement in disclosures by UCBs.

(Section 3.3.23)

*State Co-operative Banks/District Central Co-operative Banks*

Though rural co-operatives have a major share of funding in the form of deposits, the share of borrowings has also shown an increase. Loans and advances are major areas of asset deployment. The asset quality continues to be very poor for rural co-operatives. They have a high amount of accumulated losses.

The assessment of the Basel Core Principles shows that the number of principles which are compliant are three, largely compliant are 10, materially non-compliant are six, non-compliant are two and four principles were not applicable. The status of non-compliance and material non-compliance cover principles related to prudential requirements and risk management, which point to the need for strengthening these areas. Some of the recommendations to fill the gaps are as under:

(i) Given the stage of development of these institutions, there are no requirements for stipulation of capital charge for market risk, liquidity risk and operational risk. It is also premature to consider measurement and capital augmentation to mitigate interest rate risk in banking book.

(ii) There is a need to issue guidelines which give protection to bank staff who report suspicious activity, either internally or directly, to the relevant authority.

(Section 3.3.31)

*Regional Rural Banks*

Consequent to the policy of amalgamation, the number of RRBs has declined since 2005-06. The sector has also registered good growth over 2004-

05 and 2007-08 and there has been improvement in asset quality and profitability.

(Section 3.3.41)

The assessment of Basel Core Principles reveals that four principles are compliant, eight are largely compliant, six are materially non-compliant, two are non-compliant and five are not applicable. It also reveals that there are gaps in areas of risk management, internal control, abuse of financial services and accounting and disclosure. Some of the recommendations to fill the gaps are as under:

i) Sophisticated techniques, like internal risk assessment models and integrated risk management are not considered necessary for RRBs given their stage of development.

ii) As RRBs are currently in non-Basel mode, the assessment of market risk can be implemented only after CRAR is introduced.

iii) As commercial banks are stakeholders in RRBs, guidelines on liquidity risk and operational risk along the lines applicable to commercial banks can be issued to RRBs.

iv) It would be premature to issue guidelines on interest rate risk in banking book to RRBs.

v) There is no need to call for sectoral and geographical exposures from RRBs at present.

vi) While NABARD has issued guidelines regarding the separation of functions in respect of the back office and front office, it does not determine whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/ business origination. NABARD may comment on this aspect during the on-site examination of RRBs.

vii) The KYC guidelines to RRBs do not have elements like a customer acceptance policy, customer identification, verification and due diligence programme; policies and processes to monitor and recognise unusual or potentially suspicious transactions, particularly of high-risk accounts; escalation to senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; or clear

rules on what records must be kept on consumer identification and individual transactions and their retention period. Given the size of their operations and fact that the clientele of RRBs mainly comprise those under relaxed Know Your Customer norms, they may continue with the existing practice, and rigorous supervision may not be necessary. However, once their operations grow in volume and coverage, detailed guidelines along the lines of the ones issued to commercial banks, like customer acceptance policy and customer identification policy, could be considered.

viii) NABARD does not determine whether these banks have enhanced due diligence policies and processes regarding correspondent banking. Once these banks enter into full-fledged correspondent banking, guidelines on due diligence policies could be considered.

ix) Guidelines should be issued to RRBs to put in place measures to prevent, identify and report the potential abuse of financial services including money laundering. NABARD should determine during on-site examination that the banks have policies and processes whereby the staff can report any problems relating to abuse of banks' financial services to either local management or the relevant dedicated officer or to both. Further, NABARD may, in consultation with the Reserve Bank, issue guidelines whereby staff who report suspicious activity are not held liable by the relevant authority.

x) NABARD may consider removing the exemption from year ending March 31, 2009 and require RRBs to publish their balance sheet and profit and loss accounts together with auditors' Reports.

Corporate governance in the strictest sense of the term has not so far been made applicable to RRBs, as the board members are generally nominated. Nor have they been made accountable for all omissions and commissions. Though directors are nominated to RRBs, it would be desirable to make them accountable. There should be a formal board-approved policy in this regard. The Government however, feels that the RRB Boards take collective decisions and each director, whether nominated or otherwise, is equally responsible for decisions.

(Section 3.3.42)

**8.2.3 Non-banking Financial Companies**

In India, there are two broad categories of NBFCs, *viz.*, NBFCs-D and NBFCs-ND. There has been a significant decline in the deposit base of NBFCs-D. NBFCs-D have a high CRAR, low NPAs and comfortable RoA. NBFCs-ND have grown at a fast pace in recent times. Within this sector, NBFCs-ND-SI are growing at a rapid pace. This sector is characterised by low and reducing NPAs and high RoA.

(Section 3.4.11 and 3.4.12)

Both sectors show an increased dependence on borrowings as a funding source. Thus, they have a systemic linkage. Without stifling their

growth through excessive regulations it needs to be ensured that these entities do not pose any risk to the system.

Unlike banks, NBFCs do not have access to low-cost deposits. At the same time, banks' ability to lend to these entities is restricted as there are limits on banks' exposure to NBFCs. The NBFCs face funding constraints. The problem has been aggravated recently due to the difficult liquidity situation where NBFCs are facing problems in accessing funds. In this context, there is a need to develop an active corporate bond market to address the funding requirements of NBFCs.

In addition to lack of access to low-cost funds, NBFCs-D also bear high regulatory costs and, in the medium term, it may be difficult for these entities to compete with banks. There is an option for such entities to voluntarily move out of public deposits acceptance activities.

Without stifling the growth of the NBFC sector, there is need for an appropriate structure for regulation and supervision of NBFCs-ND-SI with appropriate legislative authority.

Banks and NBFCs which are under the same parent company do not fall within the ambit of consolidated supervision. A process for regulation and supervision of financial conglomerates needs to be developed.

(Section 3.4.13)

An assessment of BCPs has revealed that one principle is compliant, 13 are largely compliant, two are materially non-compliant, eight are non-compliant and one is not applicable. It also revealed that there are gaps in areas relating to co-operation, transfer of significant ownership, permissible activities, major acquisitions, large exposure limits, exposure to related parties, risk management, internal control, abuse of financial services and appointment of auditors. Some recommendations to fill the gaps are as under:

(i) Though policy initiatives have been taken to recognise the role of co-operation between home-host regulators, as no guidelines have been issued in this regard, the Reserve Bank could expedite issuing appropriate guidelines in this regard.

(ii) The Reserve Bank should explore the possibility of defining 'controlling interest'. Further, it should issue necessary guidelines to NBFCs advising them to inform the Reserve Bank of any change in significant ownership.

(iii) The Reserve Bank needs to explore the option of examining the suitability of the major shareholders and senior management of NBFCs.

The Reserve Bank should explore the option of periodically obtaining information on names and holdings of significant shareholders of NBFCs, who exert controlling influence, through off-site returns.

(iv) The Reserve Bank should issue guidelines whereby NBFCs would notify it of any substantive changes in their activities, structure and overall condition or as soon as they become aware of any material adverse developments.

(v) The Reserve Bank can consider obtaining information relating to cross-border operations and corporate affiliations as part of the off-site surveillance.

(vi) There is a need to issue guidelines for establishing thresholds, depending on their respective scales of operation, and reporting exposures above this threshold to the board, which could be verified by the Reserve Bank during on-site inspection of the NBFCs.

(vii) The requirement of issuance of guidelines on arm's length relationships and stipulations on mitigating risks arising out of related party exposure should be examined, keeping in view the developmental and supporting role played by NBFCs in promoting greenfield projects, which they do often through subsidiaries and associates.

(viii) Though there is no need to issue any guidelines on capital charge for operational risk at present to NBFCs, guidelines on management of operational risk can be issued.

(ix) The Reserve Bank needs to look into whether there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination of NBFCs-D and same can be examined during scrutiny of NBFCs-ND-SI.

(x) There can be confirmation that NBFCs have sufficient controls and systems in place to prevent, identify and report potential abuses of financial services, including money laundering, through on-site inspection.

(xi) In the interests of better market discipline, and in the context of the increasing complexities of holding structures and multi-layering, apart from diversified activities of NBFCs, the Reserve Bank could consider increased disclosures in the case of NBFCs, such as ownership structure, significant holdings and nature and types of activities and products.

(Section 3.4.14)

**8.2.4 Housing Finance Companies**

Given the increase in housing demand in the country, the National Buildings Organisation has projected demand at two million units per year and the total housing shortfall was estimated to be 19.4 million units. Housing finance is provided in the country by HFCs and banks, with the HFC's share in the housing loan segment declining over time.

(Section 3.5)

The housing finance companies have generally been able to maintain CRAR well above the prescribed level of 12 per cent. Its asset quality indicators are robust and RoA after dipping in 2005 and 2006 has increased in 2007 and 2008. HFCs are comfortably placed in terms of liquidity, as indicated by their current ratio. However, they have been experiencing liquidity problems from October of the current year, *viz.*, 2008-09. Strengthening the financial position of NHB, which is the designated refinancing institution for housing, would address their liquidity problems.

(Section 3.5.11 and 3.5.12)

Non-availability of a national housing price index hinders the calculation of LTV ratio for the housing finance sector; hence, construction of a national housing price index is a priority. This should be supplemented by the 'housing start-up index' to provide insights on the elasticity of property supply to property prices as well as the cost of housing credit. A concern expressed in recent times is that hardening of interest rates could elongate loan maturities and result in increased delinquencies in time to come. A TAG has formulated a feasible methodology for the construction of a housing start-up index in India on a regular basis and proposed an institutional structure that would be responsible for its operationalisation.

(Section 3.5.21 and 3.5.22)

Given that HFCs are akin to NBFCs, their regulation could be vested with the Reserve Bank, leaving NHB with only its developmental function to avoid any conflict of interest. However, the Government feels that there is no conflict of interest in NHB combining the development and regulatory roles as has been done by other regulatory agencies like SEBI, IRDA, and TRAI. It also feels that since the housing market in India is in its infancy, combining the regulatory and developmental functions in a single agency, *viz.*, NHB, would be beneficial for the market.

(Section 3.5.23)

In the light of recent developments, the present time is not opportune to go for government-sponsored secondary mortgage vehicles; however, the idea needs to be studied carefully.

(Section 3.5.24)

An assessment of BCPs has revealed that the number of principles which are compliant are two, largely compliant are 10, materially non-compliant are five and non-compliant are eight. There are gaps in areas

relating to home-host co-operation, permissible activities, large exposure limits, exposure to related parties, risk management and internal control. Some of the recommendations to fill the gaps are as under:

(i) There should be specific provisions in the NHB Act, 1987 along the lines of the SEBI Act, 1992 so that MoUs can be entered into with foreign supervisors to establish a formal communication mechanism.

(ii) There is a need to obtain a no-objection certificate from the home supervisor in the case of foreign HFCs intending to open a branch in India and in respect of HFCs which are wholly/significantly owned by foreign entities.

(iii) There is a need to reckon FII investments as part of the foreign shareholding of HFCs. However, this should not result in reduction in FDI limits, but there should be strong regulations in place to guard against external contagion.

(iv) The NHB Act should clearly define a housing finance company or housing finance institution, clearly delineating their permissible activities. Builders/construction companies should not be permitted to use the term 'housing finance' in their names, and the Ministry of Corporate Affairs needs to issue necessary guidelines to Registrars of Companies in this regard.

(v) The NHB should issue appropriate guidelines establishing the responsibilities of the board and senior management with respect to corporate governance to ensure that there is effective control over an HFC's entire business.

(vi) Amendment to NHB Act or issuance of appropriate guidelines should be considered to empower NHB to bring about changes in the composition of the board and senior management to address any prudential concerns.

(vii) NHB may, in consultation with the Reserve Bank, provide for a clear definition of 'significant ownership' and 'controlling interest'.

(viii) NHB needs to lay down norms for the acquisition or investment by an HFC, taking into account the entity's financial and organisational resources and the risks that could emanate from such an acquisition. NHB should issue necessary guidelines to HFCs to establish thresholds for acceptable concentration of credit.

(ix) Asset classification and provisioning norms should be specified for off-balance sheet items.

(x) NHB can define and capture information on related parties from HFCs and also put in place a mechanism to review the same. On the basis of the review, the potential risk areas may be identified and suitable guidelines contemplated to mitigate such risks.

(xi) NHB requires to issue guidelines on market risk along the lines of commercial banks for HFCs in a phased manner. The guidelines on ALM issued to HFCs should be more exhaustive and cover aspects like the existence of a contingent plan for handling liquidity problems.

(xii) NHB should consider the issuance of management of operational risk guidelines to HFCs, though capital charge for operational risk need not be earmarked at this stage.

(xiii) As regards Know Your Customers, NHB needs to satisfy itself that HFCs have adequate screening policies and processes to ensure high ethical and professional standards when hiring staff. It also needs to determine whether the HFCs have clear policies and processes for staff to report any problems related to the abuse of the HFCs' financial services to either local management or the relevant dedicated officer or to both. They need to explore issuance of guidelines which give protection to HFC staff who report suspicious activity in good faith either internally or directly to the relevant authority. Further, they need to consider issuance of guidelines ensuring whether the system of risk management and internal controls and detection/prevention of criminal activities and oversight of outsourced functions is in place in HFCs.

(xiv) NHB needs to put in place a structured mechanism which requires HFCs to notify NHB of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.

(xv) There is a need to issue appropriate guidelines to empower NHB regarding the appointment, rejection and rescinding of external auditors. There is a need to issue guidelines mandating the housing finance companies to submit consolidated financial statements and consolidated prudential returns; and empowering NHB to conduct consolidated supervision through appropriate amendments to the NHB Act, 1987.

(Section 3.5.25)

**8.2.5 Development Finance Institutions**

The number of DFIs has gradually declined, with some of the major all-India financial institutions having amalgamated with their banking counterparts over the past few years. Some of the DFIs have been reclassified

as systemically important non deposit-taking NBFCs. Increase in their cost of funding *vis-à-vis* banks have made them increasingly less competitive *vis-à-vis* banks. There has been a gradual decline in their share of total financial assets.

(Section 3.6)

**8.2.6 Insurance Sector**

The enactment of the Insurance Regulatory and Development Authority Act in 1999 has led to the opening of the insurance sector to private players. Deregulation has resulted in more diversified insurance product offerings, with a stress on marketing and distribution strategies. The insurance sector has witnessed growth in size and penetration. The FDI in this sector is currently capped at 26 per cent, though there are proposals to increase this FDI cap to 49 per cent. Though the government has been emphasising the need to enhance FDI limits, owing to the global financial turmoil as also the absence of an enabling regulatory framework, the issue needs to be addressed in the medium term. The reform process initiated by the regulator is one of a cautious and calibrated approach with appropriate sequencing of measures aimed at a level playing field, taking into account the structural constraints in the insurance sector.

(Section 3.7)

The key indicators of the life insurance segment reveal reasonably comfortable position as regards solvency and capital adequacy, though the solvency ratio of the largest life insurance company is barely at the stipulated regulatory minimum. There are no concerns as regards profitability and liquidity. There is a general trend to increase link-based business in the life sector.

The non-life segment also displays comfortable solvency. The high ratio of net claims to net premia are also an area of concern pointing to the need for better quality control in respect of underwriting new business, better risk management and reinsurance. There are some liquidity concerns as current assets are not sufficient to cover all current liabilities. The adequacy of premium, particularly in respect of public sector companies, also needs to be looked into.

(Section 3.7.12)

The stress tests carried out for two life insurance companies with different business models revealed that while the equity shock does not impact the solvency ratios of the companies significantly, increase in withdrawal experience results in improvement of solvency ratios as release of reserves in these cases outweighs the reduction in assets associated with withdrawals. The solvency ratio is very sensitive to interest rate and expense variation and the impact is more significant in respect of the life office which has a higher dependence on non-linked business. Mortality experience does not have a very significant impact on life offices.

(Section 3.7.2)

## Summary

The assessment of Insurance Core Principles reveals that the number of principles which are observed are five, largely observed are 13 and 10 are partly observed. There are gaps in compliance in areas of corporate governance, internal control, group-wide supervision, risk assessment and management, derivatives and similar commitment and fraud prevention. Some of the major issues/recommendations arising from the assessment are:

i) Given that some of the provisions of the Insurance Act 1938 are outdated, requisite amendments to various Acts have since been forwarded by the IRDA to the Government. The proposals for addressing the dichotomy arising from certain provisions of the specific legislations apart from the insurance legislation governing the industry have also been forwarded by IRDA, which should receive early attention.

ii) Increase the supervisory powers vested with IRDA as regards constitution of a consultative committee, enforcement of criminal penalties and winding-up of an insurance company.

iii) Need to look into continuance or otherwise of exempted insurers. The Government/IRDA needs to draw up a roadmap to address concerns relating to the protection of the interests of policyholders covered by them.

iv) Need to extend the regulatory requirement for the underwriting policy approved by the respective boards of the companies to the life insurance companies.

v) Need to put in place systems to ensure effective group-wide supervision by formalising the relationship through MoUs with both home and foreign regulators.

vi) A formal preventive and corrective action framework for fraud needs to be put in place.

vii) Prudential guidelines need to be put in place to ensure that earnings are retained within the insurance companies under specified circumstances.

viii) IRDA needs to address issues related to the policy framework required for risks associated with dealing in derivatives by insurance companies.

ix) The Insurance Laws Amendment Bill, 2008 and Life Insurance Corporation Act which seeks to bring amendment in General Insurance Business (Nationalisation) Act, 1972, Insurance Act, 1938, IRDA Act,

1999 and amendments to Life Insurance Act, 1956 has been introduced in the Parliament.

(Section 3.7.33)

The stress testing of the insurance sector is constrained by factors like non-availability of adequate data, heterogeneity in the insurance sector, lack of adequate disclosures in financial statements and difficulties in revaluation of liabilities in the balance sheet. Hence, both regulators and companies need to look into developing MIS to ensure data availability on a satisfactory basis and updating on a continuous basis. As evident from stress testing, life insurance companies need to pay more attention to expense management and to develop appropriate and timely MIS in this regard. The long-term nature of assets of the life insurance industry is a pointer to the need to have in place appropriate asset-liability management guidelines. IRDA needs to continue taking steps for enhancing the skill sets as also retention of its skilled staff**.** This also underlines the need for IRDA to align its salary structure with market trends.

(Section 3.7.41,3.7.42 and 3.7.43)

IRDA needs to make a beginning by introducing a risk-based capital requirement for the insurance sector. On its successful implementation, IRDA can progress towards adopting a risk-based supervisory cycle for insurance companies.

(Section 3.7.46)

The mandated investment requirements of the insurance sector, where a significant portion of the insurance funds are to be placed in low-risk, low-yield securities, to some extent act as a disincentive for companies to develop their treasury functions. As the Indian insurance industry faces the practical problem of an inadequate supply of specialised skilled professionals, particularly in the areas of treasury management and actuarial and underwriting skills in non-traditional areas, adequate initiatives are needed.

(Section 3.7.47)

Inter-regulatory co-operation will assume further importance going forward to effectively address regulatory arbitrage issues relating to derivative products, like CDOs, which could provide insurance without being within the regulatory ambit of IRDA**.**

(Section 3.7.48)

## 8.3 Financial Markets

The gradual removal of structural bottlenecks in the Indian financial markets and a shift away from the erstwhile administered rates have led to greater domestic market integration. Market rates which have shown strong co-movements are money and government securities, exchange rate and stock prices and the foreign exchange forward and money markets.

(Section 4.1)

### 8.3.1 Equity Market

The past two decades have seen tremendous growth in Indian equity markets. Beginning with the establishment of the Securities and Exchange

Board of India (SEBI) in 1988, some important initiatives that have been taken in recent times included setting up of the first demutualised exchange of the country, *viz.*, NSE; introduction of a variety of derivative products on Indian exchanges; demutualisation and corporatisation of all stock exchanges (other than Coimbatore Stock Exchange); and improvement in corporate governance practices.

Recent times have also seen significant improvement in market and settlement infrastructure and major strides in risk management by stock exchanges. Turnovers in both cash and derivatives markets have gone up and market capitalisation and returns from stock markets increased considerably till end-2007. The current year, however, has seen considerable volatility with a downward bias largely due to global developments.

(Section 4.2)

The assessment of IOSCO principles in respect of equity and corporate bond markets has revealed that the number of principles fully implemented is 20, broadly implemented are eight and partly implemented are two. All the principles relating to secondary market trading, clearing and settlement have been fully implemented. The principles relating to responsibilities and operational independence and accountability of regulator; use of inspection, investigation, surveillance and enforcement powers; assistance provided to foreign regulators; accounting and auditing standards; standards for eligibility and regulation; minimum entry standards, capital and prudential requirements and procedure for dealing with failure of market intermediary are not fully implemented. The key observations/recommendations are:

i) The Advisory Panel on Financial Regulation and Supervision and CFSA's comments as appropriate observed that significant overlap still remains between the Government and SEBI, with the Government having powers to issue directions to SEBI even if it is not a question of policy. Also, the power of the Government to remove the SEBI chairman or member giving a three-month notice has implications for SEBI's independence. Further, the power of the Ministry of Corporate Affairs to make rules and prescribe schedules in respect of prospectus, and financial statements in respect of listed companies, results in an overlap of regulatory jurisdiction. Appropriate legislative amendments are required in this regard. However, the CFSA differs and feels that checks and balances and accountability arrangements have to be part of a sustainable regulatory model as the regulator, with whatever autonomy, cannot stand in a vacuum. It also needs to be noted that the

Ministry of Finance has never exercised these powers *vis-à-vis* Statutory Regulatory Agencies (SRAs). It further considers that oversight by the Government is essential, since this could provide breadth and depth to the market.

ii) A specific conflict rule is required for SEBI staff relating to the investigation or consideration of licensing applications of related entities of staff.

iii) There is a need for a comprehensive inspection policy /programme for all intermediaries to increase the overall effectiveness of enforcement. To impart enforceability, the existing guidelines on disclosure and investment protection may be converted into regulations.

iv) The private right of action and / or a class action suit by investors could be allowed by law. The CFSA feels that as the purpose is to enhance accessibility of investors, it would be better if SAT/FSAT is further strengthened with regional branches.

v) All related party transactions which are part of the Annual Report and Audit Committee as per the Listing Agreement could be subject to shareholders' approval.

vi) In the interest of transparency, it is desirable to make public the voting pattern on important decisions by significant shareholders in relation to the capital market.

vii) Risk-based prudential capital requirement, internal control requirements and policy and procedures for dealing with failure resolution of market intermediaries are required.

viii) Research analysts who are employed by investment and broking companies, and underwriters for mutual funds need to be brought within the regulatory ambit of SEBI. Draft regulations in this regard have been formulated.

ix) Certain organisations that currently function primarily as trade and industry associations, but perform some SRO-like roles, could be considered to be accorded SRO status with appropriate safeguards taking into account aspects relating to conflict of interest.

(Section 4.2.1)

There is a need to get institutional bidders to pay upfront the total amounts bid, as the current requirement of paying at least 10 per cent of the total amount bid by the QIBs creates hype about oversubscription particularly during a bull run, which has a malign impact on retail investors.

(Section 4.2.21)

The CFSA notes that the recent volatility in stock markets has brought to the fore the resilience of the market. In spite of stock markets witnessing a rapid fall in market capitalisation, there has been no breakdown in the settlement systems. This is a pointer to the robust regulatory environment within which the equity market operates in India.

(Section 4.2.23)

The increasing volatility witnessed in recent times is a pointer to the need for market participants to improve their risk management. Hence, there is a need for stress testing of VaR limits to consider any adjustments. Simulation models need to be developed to assess the impact of such market practices, and mitigation measures could be adopted at the stock exchange level.

(Section 4.2.24)

Other issues that merit consideration are setting up of a Central Integrated Platform (CIP) with multiple nodes to enable investors to apply in public issues electronically, simplification of the debt issuance process with a view to rationalising public issues, strengthening of the inter-exchange cross-market surveillance to consider serious contagion risks and faster convergence of IAS with IFRS. Enhancement of knowledge standards for current and potential market participants is also a key issue which needs to be focused on.

(Section 4.2.25)

**8.3.2 Foreign Exchange Market**

The foreign exchange market in India is one of the fastest growing across countries, as is evidenced in both the spot and derivatives segments. Apart from increased turnover, the low and stable bid-ask spread of INR/USD is an indicator of liquidity of the market. However, since September 2008, a considerable amount of volatility has been observed in the foreign exchange market, which has led to instances of high bid-ask spreads in this period. An additional tool in the form of currency futures has been introduced in RSEs and other exchanges by SEBI with a view to further developing the derivatives market in India. The off-shore non-deliverable forwards (NDF) market has also picked up, but the market is small compared with the size of the on-shore market.

(Section 4.3)

The assessment of the foreign exchange market to IOSCO principles reveals that, while most of the applicable principles are fully implemented, there are five principles which are partly implemented. Gaps are observed in areas relating to operational independence and accountability, co-operation and detection of manipulation and unfair trading practices.

(Section 4.3.1)

Electronic trading platforms function as broking systems and as such do not require any approval from the Reserve Bank under FEMA as authorised

persons. The question is whether they should be subjected to the same regulatory discipline as brokers. Such trading platforms in India are not covered under the Payment and Settlement Systems Act, 2007. Only in the event of such trades getting translated into payment instructions resulting in clearing/settlement and the same entity carrying out these functions would the provisions of the PSS Act get attracted. Currently, foreign exchange brokers in India are accredited by FEDAI and the system has been working well. Therefore, there is no need for amending FEMA and bringing these entities under the ambit of the Reserve Bank.

(Section 4.3.21)

As regards derivatives, the need for a uniform accounting regime across banks and corporates, the desirability of banks entering into complex derivatives transactions with only those corporates adopting the revised accounting standards, i.e., AS 30 and AS 31 and introduction of disclosure of foreign exchange derivative transactions by non-bank entities are some issues that need to be considered.

(Section 4.3.23)

The enactment of the Payment and Settlement Systems Act could pave the way for guaranteed settlement of transactions by CCIL, which at present is not extended to forward trades**.** All OTC trades should be compulsorily recorded and settled through a clearing corporation. Given the current stage of capital account convertibility, it would be premature to allow on-shore banks to trade in non-deliverable forwards (NDFs), as recommended by the Advisory Panel on Financial Stability Assessment and Stress Testing, directly with Authorised Dealers in India.

(Section 4.3.24 and 4.3.25)

While it is difficult to specify any transaction as carry trade, the feasibility of having a limit in place on losses arising out of exposure to complex derivatives may require to be examined in detail. Given the increasing use of derivatives, there is a need to give high priority to 'customer appropriateness' and 'product suitability' as also capacity building among both market participants and regulators. Lack of appropriateness standards could lead to institutions being unaware of the inherent risks in such derivatives exposure, which could result in over-leveraging. Therefore, there should be adequate monitoring and regulation in this respect. Coupled with this is a need to move from the current system of monitoring of AGL to a PV01 monitor coupled with a Value at Risk (VaR) model; this will capture the risk better, and is more in alignment with Basel II norms.

(Section 4.3.26, 4.3.27 and 4.3.28))

In the interests of systemic stability the Advisory Panel on Financial Regulation and Supervision felt that all restrictions requiring underlying for hedging need to be abolished in a phased manner within a given time-frame. The CFSA recognises that the concept of economic exposure has been accepted by the Reserve Bank for permitting hedging. It believes that the

Reserve Bank could undertake an in-depth examination of the pros and cons of this recommendation before doing away with the requirement of underlying altogether.

(Section 4.3.29)

FEDAI should be made a full-fledged SRO by giving it more powers and it should be brought under the regulatory purview of the Reserve Bank.

(Section 4.3.30)

**8.3.3 Government Securities Market**

Consequent to various steps taken to develop the government securities market, like developing market infrastructure, broadening the investor base, introducing auctions and primary dealers as market intermediaries and improvement in trading and settlement systems, there has been tremendous growth in both the volume and liquidity. Trade associations, like FIMMDA and PDAI, have also played a crucial role in the development of the government securities market. With regard to separation of the debt management function from monetary management and the setting up of an autonomous Debt Management Office (DMO), in the first phase, a Middle Office has been set up in the Ministry of Finance so as to facilitate transition to a full-fledged DMO.

The outstanding amount of government securities has shown a significant increase between 1991-92 and 2007-08. One issue that has hampered development of the yield curve is the lack of tradable assets with banks, with less than 30 per cent of the total government securities being in the trading book as at end-March, 2008.

(Section 4.4)

Though the overall applicability of IOSCO principles to government securities market is not clear, an assessment of this market with the IOSCO principles revealed that the number of principles which are fully implemented are 19, broadly implemented are two, partly implemented are five and not applicable are four. Thus, most of the applicable principles are fully implemented. The principles relating to operational independence and accountability; co-operation; disclosure of financial results and procedure for dealing with failure of a market intermediary are not fully implemented.

(Section 4.4.1)

The present scenario wherein trading platforms of government securities market are owned by the Reserve Bank but managed by CCIL could

lead to conflicts of interest. The Reserve Bank could take a considered view on hiving off ownership of trading platforms in a phased manner.

(Section 4.4.22)

Accrual-based accounting for the government needs to be pursued after clearly establishing the related benefits and development of required skills and would be assessed by the 13th Finance Commission.

Though it is desirable to open the government securities market to foreign investors, it is to be approached with great caution as there needs to be improvement in the fiscal situation.

(Section 4.4.23)

The following measures can be considered for development of the government securities market.

(i) Scaling down of regulatory prescriptions for mandated investments in government securities and introduction of AS 30 would result in an increase of tradable assets. The requirement of scaling down mandated investments, however, needs to be juxtaposed against the ability of the government to fund its fiscal deficit. The CFSA feels that there is a need to find an alternate set of investors in government securities which would buttress the demand for such instruments. At the same time a reduction in SLR could increase the possibility of the banks being saddled with more illiquid and low-quality assets.

(ii) Diversification of the investor base to non-banks and retail segments.

(iii) Development of Separate Trading of Registered Interest and Principal of Securities.

(Section 4.4.24)

(iv) Availability of varied hedging instruments for effective mitigation of interest rate risk across the gamut of market participants. Exchange traded derivatives should be introduced at an early date and the settlement of all OTC derivatives should be routed through a clearing corporation. Capacity building is required to avoid the lack of understanding of a derivative product's suitability and appropriateness.

(Section 4.4.25)

(v) Though some self-regulatory functions are performed by FIMMDA/ PDAI, these organisations are not yet designated as SROs.

(Section 4.4.27)

(vi) Gradually increasing the number of trading days for short selling in government securities from five, along with appropriate borrowing/ lending mechanisms in government securities need to be put in place.

(Section 4.4.28)

The recommendations of the Working Group on Liquidity of State Government Securities need to be considered for implementation to activate the secondary market.

(Section 4.4.26)

### 8.3.4 Money Market

The Government notification under Section 16 of the SC(R) Act coupled with Clause 45 (W) of the RBI Amendment Act, 2006 has given powers to the Reserve Bank to regulate the money market. There has been an increase in the market share of market repos and CBLO with a decline in the importance of call money as an instrument. The market continues to be liquid with a low and stable bid-ask spread. Better trading and settlement infrastructure coupled with the introduction of financial market reforms have led to a decline in money market volatility. In the derivatives segment, the swap market (especially OIS), has been the active segment.

(Section 4.5)

The assessment with IOSCO principles has revealed that the number of principles which are fully implemented are 19, broadly implemented are four, partly implemented are five and not applicable are two. Thus, most of the applicable principles are fully implemented. The assessment has revealed that the principles relating to operational independence and accountability; co-operation; minimum entry standards, capital and prudential requirements and procedure for dealing with failure of market intermediary are not fully implemented.

(Section 4.5.1)

Despite a number of initiatives taken by the Reserve Bank, the term money market has not developed and remains inactive due to the inability of market participants to take a medium-term view on interest rates and liquidity, the absence of a credible benchmark, skewed distribution of market liquidity, corporates' preference for 'cash credit' over other modes of loan disbursements, and a tendency on the part of banks to deploy their surplus funds in LAF auctions rather than in the term money market. The last factor has been also one of the reasons for non-emergence of a short-term yield curve. The CFSA, while appreciating the concerns in regard to development of the term money market, does not advise a prescriptive approach to selective regulatory incentives for specific instruments. These are essentially commercial decisions and are best left to banks. More importantly, the systemic implications of any borrowing/lending patterns need to be carefully studied.

The development of active interest rate futures market would contribute to the development of term money market. For the development of the Interest Rate Futures (IRF) market, there is a case for permitting banks to take trading positions in the interest rate futures market as they are already

allowed in the OTC interest rate swap market. There is a need for permitting short selling of all kinds of money market securities in a phased manner.

Though the Reserve Bank may consider re-introduction of long term LAF, the CFSA does not support the idea of a term liquidity facility under normal market conditions. Though market development measures are necessary, care needs to be taken to ensure that these do not induce seeds of systemic instability in future and reform measures, if any, should be preceded by a potential impact analysis.

(Section 4.5.21)

In the interests of market development, broad-basing market repo by allowing AAA-rated corporate bonds to be repo-able, with appropriate haircuts, can be considered. This would also require a reasonably well-developed corporate bond market along with a transparent and efficient clearing and settlement system. FIMMDA could be accorded SRO status. Given the problems faced with CPs in the global markets, all corporate papers should be rated keeping in view the availability of appropriate liquidity back up. In the interests of market discipline, the disclosure of the nature of liquidity backup by the issuers in their prospectus to prevent liquidity and other contagion risks should be considered.

(Section 4.5.22, 4.5.23 and 4.5.24)

### 8.3.5 Development of Other Market Segments

The corporate bond market has been subdued due to factors such as lack of buying interest, low transparency and absence of pricing of spreads against the benchmark. Inadequate supply from corporates given the increased access to offshore market for Indian corporates, large issuance of credit-risk-free government securities and low-risk subordinated debts by banks as part of their Tier II capital at attractive interest rates, absence of DVP and the tax deducted at source (TDS) system for corporate bonds have acted as impediments to the development of secondary market activities.

(Section 4.6.1, Section 4.6.11)

Some urgently required regulatory and legislative initiatives that can help develop the market are:

i) Making corporate bonds repo-able in a phased manner.

ii) Consolidation of all trades reported in different reporting platforms and dissemination of the same to enhance transparency.

iii) Expediting development of hedging instruments like credit default swaps.

iv) Further simplification of the debt issuance process and phased movement towards anonymous order matching trading systems.

v) Introduction of DVP in corporate bonds and ensuring that settlement takes place through a clearing corporation.

vi) Rationalisation of stamp duty.

vii) Abolition of TDS.

viii) Introduction of reforms in pension and insurance sectors.

ix) Having timely, efficient bankruptcy procedures in place.

(Section 4.6.12)

Given the rate differentials in India *vis-à-vis* international rates without corresponding expectations related to the evolving inflation and exchange rates, opening the Indian debt market to foreign investment can raise issues of financial stability; hence, there is a need to follow a cautious approach.

(Section 4.6.13)

Though the sub-prime crisis has been a cause for concern, given the capital-raising constraints facing Indian banks, the credit risk transfer mechanism is required to gain ground. The participants should be well regulated and should follow transparent practices. Entry norms for participants should be clearly stipulated. FIMMDA could play a pro-active role by ensuring stable market infrastructure for proper settlement of trades.

Liquidity risks emanating from off-balance sheet items and the inter-linkages of CRT instruments with other markets need to be recognised. CRT instruments could be exchange traded to enhance transparency and their transactions recorded and settled through a clearing corporation. The approach to the development of securitised market should be gradual and calibrated. Transparency at every stage of the securitisation chain needs to be enhanced. In addition to complete traceability from origination to the final holder of the instrument, the components of second / higher level security must be decomposable / traceable to the basic assets. Regulators can consider stipulating specific capital charge beyond a certain threshold. Buttressing regulatory co-ordination and information sharing set up is a prerequisite for an active securitisation market.

Financial institutions need to develop capacity to measure their exposure to risk in a less benign market and economic environment. Senior management and board members need to understand the limitations and uncertainty that pervade the tools used to assess these risks and better understand the potential scale of losses the firm may face. They also need to carefully examine how well risk exposures reflect the overall risk appetite of the firm, and the size of the capital and liquidity cushion maintained in relation to those exposures. Market participants need to keep pace with changes in the market through continued investment in both risk management and in the processing infrastructure.

(Section 4.6.2)

## 8.4 Financial Infrastructure

### 8.4.1 Regulatory Infrastructure

*Regulatory Structure*

There are multiple regulators in the Indian financial system. The Reserve Bank regulates banks and NBFCs and the most part of government securities, money and foreign exchange markets. SEBI regulates the equities and corporate bond markets and the IRDA regulates the insurance sector. PFRDA as a pension regulator for the pension sector is on the anvil. Among the banks, though the Reserve Bank regulates rural co-operatives, NABARD supervises the rural co-operatives and the RRBs. NHB regulates the Housing Finance Companies. The presence of several regulators and the multiplicity of roles and objectives assigned to them can potentially introduce overlaps and gaps. Though over a period of time most of the overlapping issues have been resolved, some complications also arise because regulatory agencies, particularly the Reserve Bank, also own some of the financial institutions that they are responsible for regulatory and supervisory oversight. Also, several regulatory/supervisory agencies are mandated with a market development role, and other such functions. The CFSA feels that the presence of multiple regulators is consistent with the transitional phase of market development. Therefore, the real issue lies in ensuring effective co-ordination of the financial policies.

(Section 5.2)

There are two basic approaches to regulation, *viz.*, principles-based and rules-based and of late, a case has been made for a shift to the former from the latter. There is no dichotomy between the two approaches inasmuch as principles also contain a set of rules and, hence, both these approaches are complementary and not mutually exclusive. Hence, it would be desirable to identify a set of principles and then group the existing rules under them and consider validating the rules under these broad principles. This would also obviate the rules/regulations degenerating into ad-hocism. Recognising the varied stages of development of players across markets and institutions, it is believed that separate sets of rules would be required for different regulated entities within the broad parameters earmarked in the principles.

(Section 5.2.1)

*Supervision of Financial Conglomerates (FCs)*

The financial sector has been witnessing the growth of financial conglomerates and, associated with it, the issues relating to regulation of these entities which pose significant problems as they often create new risks while exacerbating existing ones.

Conglomerate supervision in India is in its early stage of evolution. While there is a monitoring and oversight framework for FCs, there are some legal impediments which prevent effective information sharing and joint inspections by regulators. Given the lack of clarity in the existing statutes

relating to regulation and supervision of financial holding companies, Indian FCs are generally based on the operating subsidiary model. The exclusion of the holding company structure in financial conglomerates exposes stakeholders to risks, strains the parent company's ability to fund its own core business and could restrict the growth of subsidiary.

There is no legislation specifically permitting regulation of FCs and holding companies in India. There is a need to legislate a new Act in this regard. The Reserve Bank could, in the interests of financial stability, be armoured with enough supervisory powers and also monitoring functions in respect of FCs. In the Indian context, the following steps can be considered:

(i) In cases of an FC where the apex institution is a bank holding company, an FC with a non-bank holding company (financial or non-financial) having a bank within its structure, and an FC with a non-bank financial holding company whose activity is within the regulatory jurisdiction of the Reserve Bank, irrespective of whether there is a bank within its structure, the responsibility of regulation and supervision of the holding company would lie with the Reserve Bank.

(ii) In the case of an FC with a non-financial holding company, the holding company should be explicitly within the regulatory outreach of the Reserve Bank, to the extent that the Reserve Bank is empowered to obtain information as relevant from time to time, even if there does not exist a bank within the FC structure.

(iii) As in the case of the FRB's role in the US as umbrella supervisor, the interactive relationship between the Reserve Bank and the other regulators of the insurance, securities, housing, etc. needs to be streamlined.

However, allowing 'intermediate' holding companies may not be feasible until an appropriate regulatory structure for such an entity is in place.

As regards the supervision of these entities, there could be a 'lead regulator' with supervision being conducted collaboratively by the regulators with the lead regulator co-ordinating the supervision across various jurisdictions, subject to the parameters of co-ordination being well-defined and ground rules being specified. Entities under FC functioning in a regulatory vacuum should be brought under the regulatory reach of the lead regulator. The Reserve Bank's initiative to insert Clause 29 A in the BR Act, is in right direction which would vest with it the powers to inspect the books of accounts and other records of all entities that are subsidiaries/ associates of a

bank and there is a need to consider a similar change in law for other lead regulators.

(Section 5.2.2)

Unified regulation is not an end itself. In the interests of financial stability, there is a need for strengthening inter-regulatory co-operation and information sharing arrangements both within and across borders among the regulators.

In the Indian context, while LoLR as also regulatory and supervisory functions vest with the Reserve Bank, an arm's length relationship between the Board for Financial Supervision and monetary function including the LoLR already exists. Any further separation of the two functions could lead to loss of synergies between the regulator, monetary authority and LoLR from the stability perspective.

(Section 5.2.21)

*Self Regulatory Organisations*

IOSCO principles recognise that SROs need to be encouraged for efficient market development. The IMF code for Transparency in Financial Policies asserts that SROs should be subject to the same standards of transparency as the regulatory agencies. In the Indian context, SEBI has guidelines in place for SROs, but there are yet no formally recognised SROs under these regulations though some associations/trade bodies perform SRO-like functions. SEBI is in the process of modifying SRO regulations in consultation with international agencies. In the insurance sector, there are some entities like the Life Insurance Council and General Insurance Council performing role of SROs. Further, the Central Government and IRDA have established the Indian Institute of Insurance Surveyors and Loss Assessors to promote self-regulation and professionalism amongst surveyors. The Reserve Bank is yet to evolve any guidelines for recognition and approval of SROs in the areas of money, government securities and foreign exchange markets. There is some ambiguity about the SRO status of certain organisations such as FEDAI in the foreign exchange market and stock exchanges in the securities market, which should be resolved.

SROs no doubt play an important role by reducing the burden of the regulator, thereby allowing it to focus on policy issues. They have an inherent advantage of being able to respond more quickly and flexibly than the regulator to changing market conditions, increase the pace of development since industry and regulator would align their efforts towards a common goal and self-regulation culture could help increase investor confidence and keep the momentum of market development at a steady pace.

Formal oversight by the regulator in respect of SROs is a necessity. As SROs are essentially trade bodies, it could raise issues relating to conflict of interest; hence, it is necessary that issues like the arm's length relationship of SROs with associated trade bodies and their corporate governance policies need to be looked into by the regulator before according SRO status to any

entity. Granting SRO status to any institution would thus necessitate the fulfilment of certain preconditions like introduction of transparent policies by the regulators for defining, identifying, and approving SRO status to institutions which are already performing, implicitly or more explicitly, self-regulatory functions in the financial sector. This could be a first step that would pave the way for evolving more generalised policies towards self-regulation, after some experience is gained in the functioning of these organisations.

(Section 5.2.3)

*Independence of Regulatory and Supervisory Authority*

Independence has different dimensions encompassing regulatory, supervisory, institutional and budgetary aspects. Independence of regulatory agencies is important for financial stability. Of the three major regulatory agencies in India, while SEBI is empowered to frame regulations without the approval of the Central Government and operate and exercise its powers given under statutes, there are certain legal provisions in the SEBI Act which restrict its independence. In this context, the powers of the Government to issue directions on questions of policy are similar to the powers of the Central Government *vis-à-vis* other SRAs. As regards the powers of the Central Government to supersede the Board of SEBI and powers to call for Reports, they are accountability arrangements within a constitutionally valid regulatory architecture and cannot be interpreted as dilution of regulatory autonomy. It also needs to be noted that the Ministry of Finance has never exercised these powers *vis-à-vis* Statutory Regulatory Agencies (SRAs). Though the Reserve Bank enjoys autonomy in respect of framing regulations and issuing directions to banks and also legal protection for its actions, the Central Government may remove the Governor or Deputy Governor from office without specifying any reasons. However, considering the Reserve Bank's success as a regulator amidst its diverse activities, and also the fact that by convention the Reserve Bank's operational independence *de facto* is fairly well established, there is no real requirement to amend the law to include specific clauses detailing circumstances in which the Reserve Bank Governor/ Deputy Governor could be removed. As regards IRDA, the issue relating to financial independence has been taken up with the Government about transfer of IRDA's funds to the exchequer. Regulators provide a public good at a cost which underscores the need to maintain their financial independence. The financial independence of the Reserve Bank, SEBI and IRDA is considered generally adequate.

(Section 5.2.4)

*Regulatory Co-operation*

The presence of multiple regulators is consistent with a transitional phase of financial development; however, the multiplicity of their roles could lead to an increase in the scope of regulatory overlaps. In the interests of financial stability, for effective regulation and supervision. the issues of regulatory co-ordination have become increasingly crucial. At present, co-operation and information sharing between the regulatory agencies is handled by a formal standing committee – the High Level Co-ordination Committee on Financial and Capital Markets (HLCCFM) – to address matters which have a bearing on the financial and capital markets. It has been recommended that this arrangement needs to be institutionalised and brought under a formal and transparent arrangement and various measures to strengthen it have also been suggested. However, the recent crisis has highlighted that institutionalisation and formalisation of co-ordination arrangements may not be of much help and the same might turn out to be counter-productive. A more appropriate solution could be a 'consensus' approach by the members of the HLCCFM as is currently practised. The CFSA therefore views that the current arrangements are adequate as they have served the test of time of maintaining systemic stability through inter-regulatory co-ordination and no further stringent formalisation of arrangements would be necessary. The arrangements would however need to be continuously monitored and the effectiveness of the HLCCFM strengthened through greater exchange of information in a need-based and timely manner. One of the members , however, felt that formalisation of HLCCFM with a clear mandate is particularly important in times of crisis, for timely and effective crisis resolution.

Associated with the issue of regulatory co-operation is the issue relating to inter-regulatory co-ordination with overseas regulators. This has gained importance in view of the enhanced need for supervision of cross-border financial intermediaries in the context of greater integration with external markets. An early adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators will be needed through appropriate interpretation of the existing legal statutes and undertaking legal amendments, if necessary. This will enable signing of MoUs and joint inspections, in addition to effective supervision of banks or financial institutions having cross-border presence and operations. However the pros and cons of such an arrangement need to be examined before taking a firm decision.

(Section 5.2.5)

*Co-ordination Between On-site Supervision and Off-site Monitoring*

In order to reap the full benefits of synergies arising out of the complementarity of effective supervision, there is need as well as room for enhancement of co-ordination between on-site and off-site supervision.

(Section 5.2.7)

*Overlaps in Market Regulation*

To begin with, there had been considerable overlap of regulations between the Reserve Bank and SEBI which have been over a period of time addressed to a great extent by the passing of appropriate legislations. However, there remains significant overlap between SEBI and the Ministry of Corporate Affairs in respect of matters related to equity and corporate debt markets.

The issue relating to certain competing products issued by different sets of institutions falling under different regulatory regimes raises questions regarding a level playing field in respect of marketing such products. Hence, it is desirable that a co-ordinated view could be taken in respect of overlap and conflict of regulatory jurisdictions, taking on board the various regulations in this regard.

(Section 5.2.8)

*Capacity Building*

Given the innovations that have taken place in the banking arena coupled with new developments in areas like risk management and Basel II, the issue relating to capacity building both from the perspective of the regulated and the regulator has gained importance. The case is similar with the securities market and insurance sector which has a plethora of newer and more complex products.

Recent incidents underscore the importance of capacity building among the regulators. Associated with this issue are aspects relating to incentive structure to attract and retain talent and training and development issues. However, there cannot be comparisons in pay packages of regulators and regulated entities given the difference in the work environment and job content among these entities. Hence, it may be more appropriate for the regulator to aspire for an 'adequate' incentive structure that would enable them to attract and retain talent and qualified professionals, rather than aiming at fully market-related packages.

In this context, the following measures could be considered:

(i) Identification of people with the right skill sets for the right jobs within the existing staff.

(ii) Recruit laterally from the market, at middle and top management levels, experts with professional competence and the requisite skill sets.

(iii) Develop a core team in each area requiring technical expertise and focused attention, e.g., in risk management, derivatives, product innovation, etc.

(iv) Re-look into the transfer policy to enable competent people to be retained in their core areas of expertise.

(v) Increase training in areas of risk management and derivatives, and dovetail the training requirements with postings. The training programmes should be more systematic and focused on the development of core competence.

(vi) Streamline systems and procedures within the institutions, facilitating flexibility and improved and faster decision making.

(vii) Develop an appropriate incentive structure in terms of pay packet, career progression and performance incentives to attract and retain talent which should be in tune with changing times.

(viii) Develop a second line of professionals and have an appropriate succession plan, thereby augmenting institutional memory.

(Section 5.2.9)

### 8.4.2 Liquidity Infrastructure

Until end-2007, large capital movements have necessitated the Reserve Bank to sterilise the excessive monetary impact of inflows. The total absorption of liquidity from the system by the Reserve Bank in line with the monetary policy stance from time to time gets reflected among the use of instruments of LAF, MSS and open market operations. There has been symmetric treatment of large capital outflows with respect to these instruments during 2008-09.

(Section 5.3)

*Volatility in Overnight Rates*

The volatility witnessed in overnight rates at the end of the quarter due to advance tax payment and year-end considerations for banks gets exacerbated due to difficulties in accurately estimating cash flows of the Government accounts, largely arising from difficulties in projecting the receipts and payments of governments. Systems and procedures need to be developed for smoothing out well-known spikes in call money rates arising out of the quarterly tax payments. Hence, there is a need to strengthen the management of government cash balances. Introduction of the auction of Central Government surplus balances with the Reserve Bank in a non-collateralised manner could be considered, which would also make available the government securities in the Reserve Bank's investment accounts for its own market operations.

The overnight segment of the money market shows some volatility due to lack of liquidity. The management of overnight temporary liquidity is incidental on accurate liquidity forecasts, which currently is not very precise.

There is a need for strengthening the asset-liability management of banks including the development of the term money market as also the development of liquidity forecasting models. This also underscores the importance for development of skills through capacity building. There is also a need to refine the indicators of liquidity. This is necessary both for better monetary/credit management and to minimise systemic risk and financial crisis propagation.

(Section 5.3.1)

*Limitations of LAF Operations*

Introduction of LAF has been a major step as regards money market operations. However, it has also led to a passive role adopted by some banks in managing their day-to-day liquidity position. In recent times, the operations also have been constrained by the availability of securities with the Reserve Bank, and the surplus SLR position of banks.

Additional collaterals like high-quality AAA-rated paper for conducting repo may be explored. This would require further institutional progress in the form of better transparency and delivery and settlement procedures in respect of the corporate bond market. The current crisis has exacerbated the collateral policies followed by various central banks. Though absorbing part of the cost through central bank liquidity management and back-up liquidity facilities is beneficial, since liquidity carries a cost, it is important that market participants have an incentive to recognise and bear some of the cost, through the way in which portfolios are structured. This issue needs further detailed discussion before introducing additional measures.

As regards the corridor for overnight money markets, a narrow or a broad corridor at any time is the result of circumstances and the Reserve Bank has to constantly look at monetary operations so that the integrity of the corridor for overnight money market can be sustained.

(Section 5.3.2)

*Issues Related to CRR*

Though CRR has been increased in recent years to manage the liquidity generated by foreign exchange operations and control inflation expectations, and its use largely depends on prevailing monetary, macro and liquidity conditions in the economy, the medium-term goal should continue to be to bring down the CRR to a low or minimum as also stated by the Reserve Bank.

(Section 5.3.3)

*Introduction of a Term Liquidity Facility*

In the absence of any short-term liquidity window from the central bank, in a range of about 15 days to three months, banks find it difficult to lend short term. The Panel on Financial Stability Assessment and Stress Testing felt that the present LAF alone does not adequately address the liquidity needs of the banking system in periods of market tightness. An appropriately designed term liquidity facility can provide powerful incentives to develop the term money market. Reintroduction of a general refinance facility against loan assets and government securities to commercial banks has been recommended. The CFSA observes that currently the Reserve Bank has a number of instruments for liquidity management, like OMO, LAF and adjustments in CRR and SLR. The extension of term liquidity facility of late in some countries like the US needs to be seen in light of the present financial crisis and due to abnormal conditions prevailing in the market. Hence, there is no need to introduce a term liquidity facility as instruments available at the disposal of the Reserve Bank are sufficient to take care of any eventuality, under normal circumstances.

(Section 5.3.4)

*Conventional Role of the Reserve Bank as LoLR*

Recent events following the sub-prime crisis like the treatment of Northern Rock in the UK and Bear Stearns and AIG in the US have highlighted the need for more careful management of liquidity risk. The RBI Act empowers the Reserve Bank to provide assistance in times of crisis. Central banks need to distinguish between institutions whose liquidity pressures stem primarily from a breakdown in financial market functioning and those whose problems fundamentally derive from underlying concerns about their solvency. The choice of tools in times of crisis would vary depending on the circumstances of the case. The Reserve Bank's interventions should depend upon specific circumstances and judgment about contagion and systemic stability and it would not be practical to lay down upfront the extent and circumstances under which it would play the role of LoLR. This is all the more so as any blueprint of LoLR would constrain the Reserve Bank from taking unconventional measures, if needed.

(Section 5.3.5)

*Impact of Capital Inflows*

In emerging markets, capital flows are often perceived to be relatively more volatile and sentiment-driven, and not necessarily related to the fundamentals in these markets; this often imposes substantial risks on market agents. The key issue for the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or temporary and subject to 'sudden stops' and reversals. There is a need to examine the likely implications of excessive inflows and outflows on monetary operations. Strategic management of the capital account would warrant preparedness for all situations.

(Section 5.3.6)

*Policy Responses to Shocks of Financial Turmoil*

The recent sub-prime turmoil caused the shock of reversal in capital flows combined with increase in spreads. Consequent to greater integration of financial markets, India has of late been experiencing the challenge of managing liquidity. The reversal of capital flows, difficulty in refinancing of ECBs and availment of trade credit despite buoyant FDI inflows has affected the equity market and, consequently, mutual funds have faced redemption pressure. This has also impacted the exchange rate and the rupee has depreciated. The reversal of flows has also affected domestic liquidity as corporates, due to problems in availing finance from abroad, have started approaching the domestic market. This has meant more banks approaching the Reserve Bank for repo, causing pressure on the LAF window. The additional liquidity requirements can be met through a cut in CRR, LAF injections, winding down or MSS buyback and by providing general or sector-specific re-finance facilities.

The adverse impact on domestic rupee liquidity due to the reversal of capital flows can be countered by the Reserve Bank substituting net foreign exchange assets as source of reserve money with net domestic assets in its balance sheet, so that the domestic primary liquidity is sustained adequately to meet the credit needs of the economy, consistent with growth prospects. The leeway available to the Reserve Bank will depend upon the monetary and credit projections. It has also to take into account the potential inflationary pressures that it could create, if actual liquidity injection becomes excessive. The Reserve Bank has taken a series of measures since mid-September 2008 in the above direction.

(Section 5.3.7)

*Unhedged Open Position of Corporates*

Monitoring of unhedged position of corporates by banks needs to be strengthened, since the currency risk has the potential to transform into credit risk. There is a need for employing better risk management practices by market participants. Though hedging is a commercial decision, the banks need to be aware of and monitor the unhedged corporate risk of their clients. In the interests of market discipline, ICAI could mandate companies to disclose their unhedged foreign currency exposure as a part of their annual reports. This could be supplemented by the Reserve Bank collating and disclosing periodically the information related to unhedged disclosure obtained from authorised dealers (ADs). Further, it feels that RBI should

consider requiring scheduled commercial banks to act on the recommendations of the Panel on Financial Stability Assessment and Stress Testing with immediate effect.
(Section 5.3.8)

*Global Imbalance*

Contrary to the perception of India being decoupled from the global economic conditions, it has been seen that the disorderly unwinding of global imbalances, particularly in the current context of financial turmoil, has affected the Indian economy indirectly. Though the exposure of banks, corporates and households in India to the external sector is limited, there is a need to be alert to unforeseen domestic and global shocks and pro-actively manage the risks. Hence, there is a need to be vigilant and remain in a state of constant preparedness for meeting any adverse consequences in the face of disorderly unwinding of global imbalance.

(Section 5.3.9)

*Financial Integrity*

The negative consequences that money laundering may have on the financial sector, real sector and the external sector, and the resultant risk of inevitably undermining public confidence in the financial institutions, could deter Foreign Direct Investment (FDI) flows. This may also have repercussions on overseas banks entering into correspondent relationship with banks which are tainted by money laundering allegations. Consistent with the principle of hierarchy of capital flows, India has been making efforts towards encouraging more inflows through FDI and enhancing the quality of portfolio flows by strict adherence to 'know your investor' principle.

One concern in the context of market integrity is investment through the participatory note route by FIIs. The Government is of the opinion that since FIIs maintain records of the identity of the entity they issue PNs to and SEBI can obtain this information from FIIs, there does not appear to be any cause for concern from the KYC angle. Further, PNs can be issued or transferred only to persons who are regulated by an appropriate foreign regulatory authority. The Reserve Bank's concern is that as PNs are tradeable instruments overseas, this could lead to multi-layering which will make it difficult to identify the ultimate holders of PNs. Furthermore, the transactions of FIIs with the PNs are outside the real-time surveillance mechanism of SEBI.

(Section 5.3.10)

**8.4.3 Accounting Standards**

The process of codification of accounting standards in the form of Indian Accounting Standards began with the establishment of ICAI in 1977 and it has issued a total of 31 Indian Accounting Standards till date. Though Indian Accounting Standards are broadly in line with International Accounting Standards, now known as IFRSs, there are some gaps in areas

relating to the convergence of Indian Accounting Standards with IFRSs, in developing sector-specific guidance, authority for issuance of standards and training of professionals. Further, the recent sub-prime crisis has also highlighted, among other things, weaknesses in the application of accounting standards. Also, problems relating to recent derivatives transactions in India, wherein banks and corporates are involved in law-suits, have brought to the fore the necessity for early adoption of Accounting Standards AS 30 and 31 relating to financial instruments. The important recommendations of the Panel are:

(i) The autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and the Council of ICAI confines itself to the administrative, but not functional, control of the ASB.

(ii) There is a need for the ASB to consider the development of standards on subjects as also provide sector-specific guidance in the application of these standards, e.g., to banks and insurance companies. ICAI may issue an interpretation on a need basis for which it should constitute an independent Interpretation Committee.

(iii) Awareness should be created about IFRSs among auditors and all others who are involved in the process.

(iv) India should continue to contribute in the agenda-setting of IASB and its technical output.

(v) ICAI should continue to conduct training programs and take steps to enhance and broaden the scope, possibly with regulators (to enhance resource availability), and to impart more formalised training to preparers of financial statements.

(Section 5.4.3)

**8.4.4 Auditing Standards**

The International Standards on Auditing (ISAs) devised by IAPC, later renamed IAASB, are widely accepted in India following efforts by the AASB. ICAI has played a role in drafting the ISAs. Though ICAI has taken steps to align Indian auditing standards with ISAs, there are still some gaps which need to be addressed in areas relating to convergence with ISAs, implementation of auditing standards, strengthening the peer review, access to working papers and independence of auditors. The other recommendations are:

(i) AASB should strive for convergence with ISAs and efforts also need to be made at the Institute level. Efforts should be made to issue Exposure Drafts by the AASB when they are issued by IAASB.

(ii) ICAI needs to take proactive steps by bringing out more technical guidance and other literature to help SMEs understand new standards and aspects relating to their practical implementation.

(iii) A strong message needs to be sent to practitioners that there is no option but to comply with the new requirements, by having a suitable deterrence and compliance mechanism in place.

(iv) The Quality Review Board set up by ICAI needs to start functioning more effectively at the earliest. It should play a more proactive role as an independent oversight body for the auditing profession in India.

(v) There is a need to accelerate the process of making the Board of Discipline and the Disciplinary Committee effectively functional.

(vi) The decision of SCODA regarding the auditors of listed companies being required to submit to SEBI financial statements containing audit qualifications needs to be implemented. The principal auditor should have the obligation to review the working papers of the other auditors who have audited the financial statements of subsidiaries.

(vii) There is a need to give functional independence to the AASB *vis-à-vis* the Council of the Institute by making AASB the final authority for drafting and issuance of the Standards, and the Council confining itself to the administrative, but not functional, control of AASB.

(viii) The certification authorities/auditors should be made responsible to the respective regulatory authorities, to the extent that they are involved in certifying/ auditing entities that fall within the regulatory domain of the Reserve Bank/SEBI or any other regulator, as applicable.

(Section 5.5.3)

**8.4.5 Business Continuity Management**

Taking into account the importance of business continuity, an exercise to ascertain the level of preparedness with regard to business continuity by formulating a questionnaire, based on the *High Level Principles of the BIS Joint Forum,* was undertaken for select commercial banks. It was observed that the majority of the respondents had taken action on several facets of BCM. However, areas of concern, particularly in aspects related to human resource management and assessment of the business continuity processes of the vendors remained. Banks must continuously test and upgrade their BCM plans incorporating new/changes in their business, new developments and technology improvements.

The assessment of CCIL revealed that despite its resilience, the BCM policy of CCIL exhibited certain shortcomings, in relation to procedures of communication and management succession in case of emergency and training of alternate staff.

A BCM drill conducted by the Reserve Bank for participants in the payment systems revealed that although the exercise was conducted in a satisfactory manner and live operations were completed from the Reserve Bank's DR-site, some participants, in spite of having adequate systems to take care of business continuity, needed to ensure that these systems operated with ease in case of a contingency.

The basic issues which continue to pose a hindrance are:

i) Outsourcing Risk.

ii) Risks arising out of third-party service providers.

iii) Computer malware and unauthorised access to secure websites.

Recommended major features that require to be kept in mind while framing a BCM programme are:

i) Risk Assessment and scenario planning.

ii) Market-wide simulation with all participants.

iii) Incident response capability.

iv) Training.

v) Guidelines for BCM of third parties.

vi) System maintenance and change control.

vii) Fraud monitoring systems.

In addition to mitigating risks emanating from IT-related issues, issues relating to appropriate succession planning and proper delineation of duty in the event of a major operational disruption and continuous upgradation of training, particularly for personnel operating at alternate sites, could be considered imperative for an appropriate BCM. Of equal importance may be issues relating to proper MIS to the top management and factoring in BCM as an integral part of operational risk management for the institutions. Capacity building on the part of the regulators to assess the state of BCM in the regulated entities could also be a major area of focus.

(Section: 5.6)

### 8.4.6 Payment and Settlement Infrastructure

The smooth functioning of the payment and settlement systems is a pre-requisite for the stability of the financial system. The launching of RTGS has led to reduction of settlement risk in large value payments in the country. The setting up of NSDL and CDSL for the capital market settlements and CCIL

for government securities, foreign exchange and money market settlements have improved efficiency in market transactions and settlement processes. A series of legal reforms to enhance the stability of the payment systems have been carried out, such as passage of the Payment and Settlement Systems Act, 2007, Information Technology Act, 2000 and amendment to the Negotiable Instruments Act, 1881.

Concomitant with the growth of the economy, there has been a significant increase in both the volume and value of transactions through the SIPS. RTGS constitutes the largest segment in terms of value.

(Section 5.7)

*Systemically Important Payment Systems*

The Real Time Gross Settlement System (RTGS) and High Value Clearing System have been assessed for adherence to the Core Principles for Systemically Important Payment Systems.

(Section 5.7.21)

The Reserve Bank has been provided with a sound and well-founded legal basis for regulation and oversight of payment and settlement systems in the country following the enactment and notification of Rules of the Payment and Settlement Systems Act, in 2007 and 2008, respectively. The Reserve Bank aims to ensure that the SIPS in the country fully observe the core principles prescribed by CPSS. Subsequent to the formation of the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) in India in 2005, a number of steps have been taken under the guidance of the Board to make the SIPS in India fully compliant with the core principles. The findings of the CPSS Core Principles assessment are that the existing payment system operates cheaply and efficiently, with minimal systemic risk. The observations and recommendations in this regard are enumerated below.

*Settlement in Commercial Bank Money*

In respect of the settlement which takes place in the commercial bank money, at centres where the Reserve Bank does not operate the clearing house, the risk management measures need further review.

*Settlement Risk*

All high-value transactions should be migrated to secure electronic channels like RTGS and NEFT to eliminate settlement risk.

*Security and Operational Reliability of SIPS*

In the case of the RTGS system, the on-site hot back-up is in place, while a dedicated off-site DR site is in the final stages of implementation. The process for implementation of the full-fledged data centre in a different zone has been undertaken. Once implemented, the site would provide a high degree of security and operational reliability.

*Efficiency*

The Reserve Bank as the overseer of the payment and settlement systems has taken several initiatives to increase the efficiency of the system

by inducting technology and changes in procedures. Though the Reserve Bank does not levy any processing charges, the RTGS system charges are still priced relatively higher by banks for customer transactions compared to charges for clearing paper-based instruments. The level of utilisation of the electronic payments infrastructure has been sub-optimal. The CFSA feels that steps may be taken to optimise the utilisation of electronic payments infrastructure and reduce the charges for such transactions.

*Retail Payment Systems*

Deficiencies in retail payment systems pertain mainly to the inefficient outstation cheque collection process. The cheque truncation process may be expanded, once the system is successfully implemented in New Delhi, for streamlining the outstation cheque collection process. The Reserve Bank may strive for 100 per cent computerisation of clearing house operations.

The usage of ECS has seen a rapid increase during the period of assessment. The main deficiency in the ECS system has been the decentralised model of transaction processing in the system. While a centralised ECS has been provided, this is available only for Reserve Bank centres. To address this deficiency, a National Electronic Clearing Platform was implemented in September 2008.

The other deficiency that remains in the system is that the benefits of facilities like ECS and RTGS are not trickling down to the lower end of the customer segment. There is a need to develop solutions using newer technologies, which would allow all segments of society to gain access to the benefits offered by these facilities. Given the high level of software capabilities available in India, it is of utmost importance that this process be accelerated and that India leapfrog intermediate steps and move rapidly to IT-based systems.

The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to customers. Currently, banks allow their customers to use the internet for availing money transfer facilities like EFT, but the limited reach offered by the internet is a barrier to expanding usage through this route. Enabling usage of these facilities on mobile devices, which have high penetration levels, could result in a large portion of the population gaining access to these facilities.

The development of a fund transfer or payment system through mobile phones would not only allow reduction in the transaction costs, but would

potentially also allow use of these facilities by a large unbanked segment. Given that, in coming years, mobile phone penetration would be much faster than banking penetration, this would allow the benefits of technology to trickle down the pyramid and allow the banking community to develop products which currently might be unfeasible or unprofitable.

(Section: 5.7.21)

*Government Securities Settlement*

The infrastructure for government securities settlement systems in India is provided by the Reserve Bank, and the Public Debt Office (PDO) in the Reserve Bank functions as the depository. CCIL is the central counterparty for settling transaction in government securities. All government securities transactions are settled through CCIL on net basis on DvP III.

The laws, rules and regulations governing the securities settlement systems are contained in the Securities Contracts (Regulation) Act (SCRA) and the Government Securities (GS) Act. The GS Act, 2006 and the GS Regulations, 2007 have been brought into force from December 1, 2007 superseding the Public Debt (PD) Act, 1944 except in respect of Jammu and Kashmir.

All secondary market transactions are submitted to settlement systems electronically and confirmations are completed on the trade date itself on the Negotiated Dealing Systems (NDS). All outright securities transactions are settled on T+1 rolling basis. Repo transactions can have T+0 and T+1 settlement.

The Securities Settlement Systems for government securities is an integral part of the Reserve Bank's operations and is subject to internal oversight through its regular inspection in a pre-determined schedule and also through concurrent audit appointed by it and the Control Self-Assessment Audit. The CCIL as a CCP is subjected to periodic oversight by the Reserve Bank based on CPSS-IOSCO standards. The responsibility of the Reserve Bank with regard to government securities settlement is defined in the Government Securities Act, 2006. There is, at present, no other security settlement system for government securities outside the Reserve Bank.

The government securities market is compliant with the CPSS-IOSCO Recommendations for Securities Settlement Systems.

*Equity Market Settlement Systems*

The major stock exchanges – BSE and NSE – and their CCPs (National Securities Clearing Corporation Ltd. and the Bank of India Shareholding Ltd.) have well-laid down rules, bye-laws and regulations regarding their operations and participation requirements.

With the screen-based on-line trading system, trades between direct market participants are confirmed online at the time of trade. The trades are settled on a rolling basis of T+2 days' settlement cycle.

CCPs provide full novation and guarantees settlement, eliminating counterparty risk entirely. The dynamic and comprehensive risk management

system comprises capital adequacy norms, trading and exposure limits, index-based market-wide circuit breakers, and margin (mark-to-market) requirements. The encashability of underlying of margins, comprising cash, bank guarantees and securities is evaluated periodically. The real-time monitoring of broker positions, margins and automatic disablement of terminals with VaR margining has reduced the operational risk. A Trade Settlement Guarantee Fund has been set up to ensure settlement of transactions and Investor and Customer Protection Funds are maintained by stock exchanges to compensate investors in case of default by members of the exchanges.

The Clearing Corporation and the Central Securities Depositories (CSDs) in India are different entities. CSDs do not extend credit or operate settlement systems in India. The settlements are carried out by the CCP. The Clearing Corporation ensures DvP for its direct participants (clearing members). The CCP acts as the central counterparty for all netted transactions and effects pay-out of securities on receipt of funds.

All settlements once carried out are final and there can be no revocation of transfers at any stage. The exchanges and CCPs have well-maintained back-up systems which ensure recovery of transaction information.

Custodians holding customer securities are required to be registered with the SEBI and follow the rules and regulations specified by SEBI for protecting customer securities. Participants' operations are subject to periodic inspection by the CSD and SEBI. Internal and external auditors as well as regulators conduct regular audit inspection of the collateral deposits.

SEBI has taken measures to rationalise account opening charges, custody charges and transaction charges. There are no charges levied by the clearing corporation for carrying out basic settlement activities. The charge structure is reviewed regularly by the CSD taking into consideration the movement in the volume of transactions and costs of operations and the benefits of increased volumes by way of reduction in fee structure is regularly passed on to users of the CSD system.

CSDs and CCPs notify their market participants about various operational, systemic requirements, rules regarding risk management and other relevant rules, regulations and procedures by way of circulars and other announcements.

In order to provide clarity on the applicability of insolvency laws and finality of settlement and netting for the transactions made

through Recognised Stock Exchanges and clearing corporations in equities settlement, there is a need to incorporate specific clarificatory provisions in the SCRA.

(Section 5.7.22)

**Central Counterparties**

The Reserve Bank took the initiative of setting up CCIL, with some of the major banks as its core promoters, for upgrading the country's financial infrastructure in respect of clearing and settlement of debt instruments and foreign exchange transactions. CCIL currently provides guaranteed settlement facility for government securities clearing, clearing of Collateralised Borrowing and Lending Obligations (CBLO) and foreign exchange clearing.

*Government Securities Segment*

CCIL has played the role of a central counterparty and provided a settlement guarantee mechanism to the government securities settlement system with transactions now being settled on a net basis (DvP III), both in the funds and securities legs. Members have the opportunity to trade on the Reserve Bank's Negotiated Dealing System (NDS) or NDS-Order Matching (NDS-OM) system. Settlement through CCIL provides the members with assurance of settlement on the settlement date, reduction in counterparty exposure, operational efficiency and improved liquidity

*CBLO Segment*

CBLO provides an avenue for funds deployment of entities that have been phased out from the uncollateralised inter-bank call money market. The borrowing and lending takes place through an electronic anonymous order matching platform. CBLO operates in an STP-enabled environment, seamlessly encompassing dealing to settlement.

*Foreign Exchange Segment*

CCIL provides guaranteed settlement facility for all US dollar–Indian Rupee inter-bank Cash, Tom, Spot and Forward transactions. The matched and accepted forwards deals are guaranteed for settlement from S-2 day (two days previous to settlement) and the Spot, Tom and Cash deals are guaranteed for settlement from the trade date as the CCIL becomes the central counterparty to every accepted trade through the process of novation. Settlement of foreign exchange transactions by CCIL has resulted in a reduction in counterparty exposure, increased operational efficiency and overall lower operational costs. Foreign exchange settlement volumes in CCIL have been rising consistently through the years and have witnessed substantial growth since it commenced operations.

Some of the major observations and recommendations on the functioning of CCIL are given below:

There is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades for the CBLO

and foreign exchange segments. CCIL may endeavour to develop capacity to measure intraday exposure and margin requirement (based on intra-day exposures) for government securities, CBLO and foreign exchange segments.

Back-testing for CBLO is a must to assess the associated risks as well as adequacy of margins. However, the back-testing model is not in place for the CBLO segment. In the CBLO segment, CCIL needs to develop a model for back-testing for margining to ascertain the adequacy of margins collected.

As part of its operations, CCIL also encounters intra-day liquidity shortfalls. To tide over intra-day liquidity requirements, CCIL has availed of a dedicated Lines of Credit (LoC) from a few commercial banks.

It has been observed that, on certain occasions, the largest exposures to some participants exceeded the amount of liquid financial resources available with CCIL, particularly in the government securities and CBLO segments.

Given the significant increase in the volume of trades in the debt, money and foreign exchange markets and as the settlements at CCIL are effectively taking place at the end of the day, it would be very difficult for them to raise liquidity from commercial banks equivalent to international benchmarks. Moreover, the cost of any new LoC for CCIL from banks is expected to be significantly higher, which may lead to an increase in transaction costs. The following options may be considered to deal with the situation:

i. CCIL may be granted a Limited Purpose Banking license, so that they are able to approach the Reserve Bank or the market for liquidity by repo arrangements.

ii. CCIL can settle through continuous settlement on the RTGS. This would require that CCIL is granted full membership of RTGS.

iii. Intra-day credit provision by the Reserve Bank.

The grant of a limited purpose banking licence will enable CCIL to approach the repo window of another bank to fulfil the requirement of additional liquidity, when needed. Appropriate amendments in the legal provisions could be considered, making it easier to go ahead with issuing differentiated bank licences for this purpose.

CCIL needs to develop stress testing models for the CBLO segment. Further, in the foreign exchange segment, CCIL may evolve a clear and transparent policy to ensure prompt actions (regarding calling for additional

resources and time and manner of collection) are taken in cases when the stress test indicates that resources are inadequate. While the proposal to fix a net debit cap can be fixed for the exposure of CCIL in the government securities segment and the CBLO segment can be considered, in view of the quantum increase in the volumes of trades in government securities market and since banks are mandated to operate through CCIL, implementation of this should duly consider that it does not hamper smooth trade and settlement operations in the government securities market.

The contract between CCP and its members is one single agreement and all transactions are governed by such a master agreement and all transactions constitute a single agreement between the parties. Though cherry-picking by a liquidator is possible in India, the view is that the Indian Courts may still regard this as a valid contract due to the fact that the liquidator cannot take the benefit of a contract without its burden. Though legal assurance after the notification of the Payment and Settlement Systems Act has put the default handling authority on a comprehensive legal footing in the CBLO and foreign exchange segments, CCIL needs to evolve an objective policy on the modalities of liquidating the default position to reinforce the established default procedure for both the CBLO and foreign exchange segments.

Detailed processes for monitoring exposures are not in place. CCIL may develop processes for monitoring of settlement bank risk for the CBLO and foreign exchange segments.

Stress test methodology and the results of stress tests done by the CCIL are not disclosed to the members/public. CCIL may consider making public their stress test methodology and, if feasible, also the results.

The CFSA recognises that concentration of business with CCIL pertaining to government securities, money and foreign exchange markets helps them pool the risks and reduce the overall transaction costs for the system. CCIL has also increased its capital by way of issue of preference share capital, taking its total paid-up capital to Rs.100 crore. However, the risk management systems in CCIL should be further strengthened to address the capital, and the liquidity needs of CCIL so that the propensity for the failure of this entity, which could have systemic implications, can be prevented.

*National Securities Clearing Corporation Ltd (NSCCL) and BOISL*

The National Securities Clearing Corporation Ltd. (NSCCL) functions as a CCP and clears and settles operations in the case of the NSE; in the case of the BSE, the exchange itself serves as a CCP. The settlement of trade in the equity market (both cash and derivative segments) are settled in the BSE by Clearing House, Bank of India Shareholding Ltd (BOISL) which is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent).

NSCCL and BOISL are compliant with the CPSS-IOSCO Recommendations for Central Counterparties.

(Section 5.7.23)

**8.4.7 Legal Infrastructure**

Effective creditor rights and insolvency systems play a vital role in helping to sustain financial soundness and promote commercial confidence by enabling market participants and stakeholders to more accurately price, manage and resolve the risks of default and non-performance. The insolvency law framework for banks, NBFCs and insurance companies and the general corporate insolvency regime in India are broadly compliant with World Bank Principles. However, there are several gaps, particularly in the implementation of the extant legislations.

The assessment has brought out in detail the complexities of legal and judicial systems in India, raising concerns about the long delays in the winding-up process. Whereas a legal amendment to the Companies Act, based on the recommendations of an expert Committee, has been made, enabling setting up of a National Company Law Tribunal (NCLT), this major proposal itself could not take off due to a pending law suit. The determination of the appeal pending against the amendment to the Companies Act will have a significant impact on the implementation of bankruptcy laws in India.

Enactment of appropriate laws to ensure speedier insolvency resolution is necessary for development of the corporate debt and, particularly, the securitisation markets.

(Section 5.8)

*Legal Framework for Bank Insolvency in India*

In India, the law relating to insolvency of banks is contained in the BR Act. The stated object of this Act is the protection of the interests of depositors. The Indian legal framework for bank insolvency relating to liquidation contemplates a special regime of insolvency initiated by the Reserve Bank (either on its own or as directed by the Central Government), but under the jurisdiction of the High Court. As regards the reconstruction of a banking company, the Indian legal framework (the BR Act) has provided for a special regime administratively implemented by the Reserve Bank/Central Government by way of a scheme. The law provides for voluntary amalgamation at the instance of the banks and compulsory amalgamation at the instance of the Reserve Bank. Due to the complexity of the Indian banking sector, the legal framework applicable to insolvencies of banks which are statutory corporations, nationalised banks and those in the co-operative sector have different legal principles applicable to them.

*Assessment of Bank Insolvency Issues in India*

The Indian legal framework for insolvency of banking companies is in substantial compliance with emerging international standards. However, one major area in which there are no clear legal provisions in respect of bank insolvency is the formal legal mechanism for sharing of information with other regulatory bodies and overseas regulators and the extent of co-operation between them. The failure of co-operative banks and the rescue measures in that sector continue to be a concern on account of issues like the dual control of such co-operative banks by the Reserve Bank and State Governments. In view of several legal complexities, it may be worthwhile to have a separate common and comprehensive insolvency code for banking institutions irrespective of the nature of entity involved, which is entirely different from the general insolvency code applicable to corporates, individuals, firms and societies.

(Section 5.8.3)

*Competition Issues in Banking*

The Competition (Amendment) Act, 2007 which has recently amended various provisions of the Competition Act, 2002 raises issues of serious concern. The wide powers conferred on the Commission, even to nullify a combination, are likely to throw open issues of concern for banks and financial institutions. Considering the gravity of the matter and the repercussions, particularly from the angle of financial stability, it is necessary to have a serious look into the whole issue and, if considered necessary, for the Central Government to give necessary exemption under Section 54 of the Competition Act.

Though Section 21 A of the Competition Act provides for the Commission to make references to a statutory authority when the issue before it relates to an Act whose implementation is entrusted to that statutory authority, it is observed that the opinion of the statutory authority in such a case has not been given any binding effect on the Commission and the final decision has been left to the Commission. Going by the aforesaid principle, in respect of matters relating to banks, whose exclusive jurisdiction has been given to the Reserve Bank, it should have been left to the Reserve Bank to take the final decision in such matters and the opinion of the Commission could have been made an input for the Reserve Bank to decide. The Panel observes that the provisions of the Competition Act, as amended, are likely to raise issues of regulatory overlap/conflict in future and pose a serious problem to the financial sector.

(Section 5.8)

At present, the mechanism of rehabilitation through the SICA has not been effective. The winding-up petitions and cases referred to BIFR take very long for final disposal. According to the 'Doing Business Report' of the World Bank, the recovery rate in India is the lowest among all the countries listed

and the average time for completing the winding-up process is the highest, at 10 years.

The CFSA, therefore, would place top priority for the authorities to improve and rationalise the systems and procedures so that the huge loss inflicted on stakeholders on account of the insolvency process in India can be substantially minimised. The need to have an efficient bankruptcy law for the financial sector is essential from the point of view of the efficiency of the systems, as well as the stability of the financial sector.

(Section 5.8.5)

*Other Aspects Relating to Insolvency*

The lack of a registry which keeps a record of the security interests created in respect of movable properties is another lacuna in the system of registration of security interest. Even though legal principles governing enforcement mechanism are adequate, there is delay in implementing these principles at the ground level. The recovery mechanism in the case of unsecured credit is less efficient and cases are pending for execution with the DRTs due to lack of information about the properties of the debtors. Though there are provisions in respect of calling for claims and their adjudication in liquidation proceedings, in case of any dispute the matter is placed before the court for its decision. This takes a long time to be resolved and the claims of other creditors are also held up due to such disputes. The lack of judicial time, expertise and consequent lack of proper appreciation of issues pertaining to insolvency are causing delays in deciding court cases.

*Legal Framework for Creditor Rights*

The contractual rights of creditors are recognised under the laws in India. Certain provisions of law which give priority to sovereign claims over the claims of secured creditors have been causing concern to the secured creditors as regards their security interest. The law should provide that the priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors. Since there are no comprehensive credit guarantee schemes in the market, it would be worthwhile to improve the scheme notified under the DICGC Act, 1961.

*Security (Immovable/Movable Property)*

Even though the general laws permit creation of security interests over immovable properties, certain revenue orders issued by State governments have acted as disincentives to extend loans by creditors. States should take

steps to remove the restrictions on creation of security interests in favour of banks and financial institutions, in respect of lands belonging to specified categories, by rescinding the revenue orders or by way of legislations, as the case may be.

Stamp duties charged by the States should be nominal, so that they do not hamper the transfer of immovable properties and interests therein.

It would be worthwhile to have a common legislation dealing with the creation and registration of security interests (collaterals) irrespective of the nature of the security and its location. Eventually, the Central Registry should be the sole registry of all security interests.

*SARFAESI Act and Registry Systems*

There is a need to amend Section 14 of the SARFAESI Act for providing an enabling provision for the district magistrate to delegate his powers under the SARFAESI Act to other executive magistrates in the District, so that the delay in taking possession/control of the secured asset may be obviated.

The SARFAESI Act may be extended to cover security interest in agricultural land beyond a specified holding, say five acres, which would be exempt from the provisions of the SARFAESI Act.

The Central Registry under the SARFAESI Act, which can take care of a major part of the transactions of banks and financial institutions, is yet to be set up. The system of registration of security interest in respect of immovable property, motor vehicles, intellectual property and in respect of assets of companies provides adequate notice of the creation of security interest to the general public. However, there is no registry which keeps a record of the security interests created in respect of other movable properties.

The Central Registry should be set up urgently to have a central and reliable record of all security interests created by banks and financial institutions. The Central Registry should also be allowed to register all transactions creating security interests (both in movable as well as immovable property) by entities/individuals in addition to those of banks/financial institutions. For this purpose, it may be appropriate to bring a separate legislation in respect of the Central Registry. In course of time, the Central Registry (with an adequate number of branches all over the country) should be the sole registry for registration of all security interests over properties and the registries under various statutes should be wound up with suitable amendments to the respective Acts dealing with registration of security interests. The Central Registry should be constituted to provide a good database and reliable record on the creation of security interests/charges under the SARFAESI Act, This would also be an authentic source of public notice. It should also be allowed to register all transactions creating security interest (both in movable as well as immovable property) by entities/ individuals other than banks/ financial institutions.

DRTs granting *ex parte* stay orders against sale of securities by banks/ financial institutions under Section 13(4) of the SARFAESI Act is a matter of

serious concern. A suitable provision to safeguard the interests of lenders needs to be inserted in the SARFAESI Act.

There is a need to computerise the records of Registrar of Assurances, to link them to the Central Registrar and provide an online search facility. Measures should be taken by all the State Governments in this regard. The online search facility has to be provided to verify the existence of a security interest over a patent, trade mark or design after making payments online. There should be express provision for the registration of charges over trade marks under the Trade Marks Act, 1999.

*Jurisdiction of Recovery Tribunals*

Even though the number of new cases filed in the DRTs has come down owing to the enactment of the SARFAESI Act, the number of pending cases is still large. In order to minimise the delay, the number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rs.1 crore and above.

*Risk Management and Corporate Workout*

There is a need to grant priority (by statute) to the claims of banks or financial institutions in respect of the financial assistance given to rehabilitate a sick/weak company in financial distress. Such priority of claim should also extend while disbursing the assets in liquidation. However, NCLT should be made functional for any significant improvement in the restructuring process.

*Legal Framework for Insolvency*

To achieve a more transparent, predictable and sound insolvency system, ideally there is a need to consolidate all the separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in such insolvency. The CFSA however notes that the Panel on Financial Stability Assessment and Stress Testing has recommended a separate insolvency code for banks.

There is a need to provide for priority to the financial assistance given at the time of rehabilitation to entities that have suffered losses as a result of matters beyond their control, while disbursing the assets in liquidation, by inserting a special provision in the Companies Act.

It is advisable to keep insolvency procedures of entities with systemic risk like banks/insurance companies separate from the insolvency relating to ordinary companies, and the law should provide for a time-frame to conclude liquidation proceedings.

There is no provision in law enabling cross-border insolvency proceedings. The UNCITRAL Model Law on Cross-border Insolvency with suitable clarificatory provisions should be inserted in the statute to the effect that the special insolvency regimes for banks, NBFCs and insurance companies would be outside its purview.

The SICA is used to deal with the rehabilitation of sick industrial undertakings. In terms of the Act, the board of directors of a sick industrial undertaking could make a reference to the BIFR, set up under the provisions of the Act, for determination of measures to be taken against that undertaking. BIFR would then make an inquiry into the working of the company. Winding-up petitions and cases referred to BIFR take very long for final disposal. Companies often use the SICA to prevent creditors from proceeding against them; this is on account of the statutory stay on initiation/ continuance of suits or other legal proceeding once a reference is made to the BIFR. The mechanism of rehabilitation through SICA was not effective. The new provisions introduced in the Companies Act vide the Companies (Second Amendment) Act, 2002 once brought into operation, are expected to improve the rehabilitation mechanism. A separate bench of NCLT should be set up to deal with cases involving rehabilitation involving loan amounts of Rs.10 crore and above.

*Provisional Measures and Effects of Commencement*

The Companies (Second Amendment) Act, 2002 should be brought into operation since it seeks to expressly empower the Court/Liquidator to take relevant measures to protect the properties of the company during the proceedings. The law provides for a general stay on suits and proceedings against the assets of the company. However, such a stay is not applicable to a secured creditor who enforces his security interest outside the winding-up proceedings. Unless and until the Court has passed an order in an insolvency petition, the company is free to deal with its properties and this may erode the realisation, unless a Provisional Liquidator is appointed to manage the affairs. The law should provide for an automatic stay on creation of further liabilities on or alienation of the company's assets, camouflaged as in the ordinary course of business, after the presentation of a winding-up petition and service of its notice on the company. As a safeguard against abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and malafide petitions.

Because of delays, the actual realisation of assets in liquidation is very low and there is a need to provide for an expeditious disposal mechanism for better valuation.

*Creditors' Committee: Administration and Treatment of Contractual Obligations*

The law should provide for a creditors' committee at the initial stage of insolvency proceedings to consider the reorganisation of the company. There should be provision for an exclusive creditors' committee/assembly in

insolvency laws, when the liquidator is not a creditor-nominated liquidator. Such committees should be empowered to participate in the decisions along with the liquidator and to file a report independently to the court/tribunal for improving liquidation proceedings. The law should provide for nominating unsecured creditors in the creditors' committee to ensure their participation and to safeguard their interests.

The Companies (Second Amendment) Act, 2002 should be brought into operation quickly to empower the Liquidator/Court to protect the assets of the company and to even sell the undertaking as a going concern.

There should be express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during reorganisation and winding-up. A limited extent of certainty has been introduced by way of the Payment and Settlement Systems Act, 2007 in respect of contracts in a payment system. However, the position regarding the treatment of Over-the-Counter transactions in derivatives settled outside 'payment systems' regulated under the Payment and Settlement Systems Act, 2007 especially the closing-out provisions in such contracts, is not yet clear.

The implementation of the provisions relating to the receipt of claims and their process in liquidation needs to be improved to reduce delays.

*Re-organisation; Judicial Decision-making and Enforcement of Orders*

The law should provide for setting time limits for the approval of a plan. It would be necessary for the legal provisions to limit the number of plans that can be submitted for sanction before the court or provide for the automatic lapse of a scheme if the same is not approved within a specified period, say within three months or six months from the date of submission.

In rehabilitation proceedings under SICA, there should be a provision for the appointment of a creditor-nominated representative/committee.

There is a necessity for incorporating provisions that would compel companies to report the implementation of their plan periodically to the Regional Director/Government till all the terms and conditions of the plan are substantially complied with and the court passes final orders to that effect.

Certified copies of court orders should be made available online to improve the efficiency and utility of the system.

The lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency are causing delays in

deciding court cases. This can to a large extent be solved if the NCLT and the NCLAT are set up.

(Section 5.8.7)

**8.4.8 Corporate Governance**

There is a comprehensive corporate governance framework in India for listed companies and the Listing Agreement forms an important pillar of corporate governance framework. However, there is also a need for strengthening the corporate governance framework for unlisted companies. There are various legal and regulatory requirements pertaining to corporate governance in place. The roles and responsibilities of the various regulators are clearly defined and there are co-ordination mechanisms in place for interaction among various regulators. A number of initiatives have been taken to improve the rights of shareholders. There are enabling provisions in place which allow shareholders to participate in and be informed of decisions concerning fundamental corporate changes. Though there are enabling provisions in place which permit participation of shareholders in general meetings, alternate methods for voting needs to be explored, coupled with spreading awareness through investor education. Ownership through cross-holdings and use of trusts and private companies for owning shares in group companies give rise to opaque structures, which needs to be addressed.

*Good Corporate Governance Practices*

The quality of corporate governance in Indian companies would be a key determinant affecting their ability to attract capital, business, global partners and quality manpower.

*Listed Companies*

Certain requirements of Clause 49 of the Listing Agreement are non-mandatory. Given the fact that the listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted, the listed companies may also be required to disclose the reasons for non-compliance with non-mandatory requirements.

It may be worthwhile to gather information on the experience of the companies which have chosen to implement the whistle-blower mechanism and to consider a further course of policy change, if any, in this area.

There is a need for strengthening the existing framework with regard to risk management in the listed companies. Introducing the requirement of having Risk Committees can be specifically explored in this regard.

While international practices and developments have apparently been factored into the evolution of the corporate governance framework in India, the corporate governance code should be constantly reviewed in the light of changing global scenario.

*Issues Relating to Investors*

The Panel notes that there are certain constraints which prevent a shareholder from participating in AGMs/EGMs due to their dispersed

geographical spread. To increase participation by shareholders, initiatives like the following should be considered: the AGM could be held where majority shareholders reside; alternate methods of voting which are convenient to shareholders could be explored; and investor associations can play an active role in providing a platform for co-ordination amongst investors.

Institutional investors need to be encouraged to declare their voting policy and to effectively participate in the corporate decision-making as they are expected to have better knowledge and understanding of the affairs of the company. The possibility of stipulating specific requirements either as good practice or mandatory requirements needs to be explored.

*Independent Directors*

Though in the present scheme of things, substantial importance is given to independent directors in listed companies, there is no mandatory requirement pertaining to their tenure. There is a need to prescribe an upper limit on the tenure of independent directors in the law and, in due course, this could be incorporated through an amendment to the Companies Act.

*Penal Provisions*

Ownership through cross-holdings and use of trusts and private companies for owning shares in group companies gives rise to opaque structures. There is, therefore, a need for strengthening the disclosure mechanism to bring about greater transparency in ownership structures to address concerns arising through cross-holding and opaque, non-transparent structures. Stringent penal action needs to be taken whenever such undesirable practices are unearthed.

There is a need for strengthening the enforcement mechanism by focusing efforts on tracking defaulters or non-compliance by the company, which would act as deterrents for future non-compliance and also boost the confidence of investors in the system.

Appropriate penalties may be provided for in the law for non-compliance pertaining to related-party transactions. Penal provisions for fraudsters may be strengthened in corporate law by providing for the disgorgement of gains and confiscation of assets.

*Institutional Mechanism for Resolution of Cases*

Though India today has a robust regulatory framework, there are bottlenecks due to delays in the judicial process. The liquidation process is

time-consuming and lengthy, thereby leaving hardly any effective remedy for stakeholders other than secured creditors. It has been observed that setting up dedicated courts for certain areas has led to expeditious disposal of cases. An effective institutional mechanism for time-bound resolution of cases needs to be created urgently.

*Other Issues*

The unlisted sector is a significant part of the corporate world in India. In addition, a number of Indian groups have deliberately moved into the unlisted sector, attracted by less onerous requirements and presumably not deterred by potentially lower access to capital. Though a strong corporate governance framework is in place for listed companies, there is a need for strengthening the focus on unlisted companies to strengthen the overall system. Accordingly, it is recommended that a separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act by the Ministry of Corporate Affairs, which takes into account the interests of stakeholders in such companies. Unlisted companies can voluntarily evolve and adopt a code of corporate governance. Trade Associations like CII, FICCI and ASSOCHAM can play an important role in this regard. The Ministry can also consider mandating, in respect of unlisted companies above a particular size, compliance with applicable provisions of Clause 49 of the Listing Agreement. The role and responsibility of Ministry of Corporate Affairs may be crystallised in the Companies Act itself, especially for mergers and amalgamations.

(Section 5.9.3)

**8.4.9 Deposit Insurance**

In India, deposit insurance is offered by DICGC which is fully owned by the Reserve Bank. Deposit insurance is mandatory and covers all banks (commercial/ co-operative/RRBs/LABs). The coverage limit is roughly 2.4 times the per capita GDP against the global average of 3 times per capita GDP.

As DICGC is a fully-owned subsidiary of the Reserve Bank, it gives the perception of an inherent conflict in the organisational structure. This issue is attempted to be addressed through the functional separation of the deposit insurance system from the regulatory operations of the Reserve Bank. If DICGC is to be provided *de jure* independence, the need for building up a stand-alone insurance fund assumes importance. A fund, financed solely through premiums paid by insured parties, would incentivise deposit insurance providers to not only perceive a direct stake in the financial health of the insurance system, but also provide motivation for them to scrutinise deposit insurance operations and maintain industry self-policing.

Trends in claims settlement are indicative of the fact that there is a significant element of cross-subsidisation. Also, the costs of such settlement have been increasing over time. While, the possibility of introducing a risk-based premium which may discourage excessive risk-taking by insured banks, motivate them to improve governance and address the issue of cross-

subsidisation implicit in the current system, certain issues need to be factored in before switching over to risk-related premiums. They are:

i) Systemic risks posed by big banks and its conglomerates and stabilisation of the supervisory system for the banking sector as a whole.

ii) A risk-adjusted premium could prove to be expensive for weak financial entities.

iii) The consolidation and restructuring process is underway in the banking sector in certain segments which may lead to a change in the banks' risk profile.

In this context, therefore, legislative amendments to raise the ceiling on flat-rate premium in the interim may be considered.

The deposit insurance fund (DIF) of DICGC is funded by the collection of premia from member banks (*ex-ante*) and the fund is invested only in Central Government securities. The interest income from such investments and cash recovery of assets of failed banks also contribute to DIF. There is always the possibility that the need for funds can surpass the resources, especially in a crisis which could be filled up by temporarily borrowing from the central bank or by a bail-out from the Government directly. In this context, the adequacy of the DIF is an important issue for ensuring solvency of the fund and maintaining public confidence in the deposit insurance system. It would be necessary to constantly monitor the DIF and perhaps, if the situation arises, there will be a need to take a view on the issue of raising the premium in order to strengthen the DIF.

Given that DICGC is acting as a trust for the public at large and small depositors in particular, there is a case for providing exemption from income tax to the Corporation which could be considered by the Government.

The issue of DICGC requires to be taken on board to examine the viability of the regulated entity at the 'entry point' and on an ongoing basis. A Committee, comprising the regulatory/supervisory departments of the Reserve Bank and DICGC should be constituted on a standing basis for regular sharing and exchange of information on regulated entities.

The issue whether DICGC needs to be involved in the resolution process to reduce the time-frame to meet the claims of insured depositors needs to be deliberated upon. Timely winding-up operations of failed institutions would require extensive legal reforms and merely empowering

DICGC may not solve the problem. Instead, delinking the settlement of DICGC claims from liquidation when payment to depositors is stopped by virtue of the Reserve Bank issuing prohibitory orders against banks could be considered. This would require amendments to the DICGC Act and the BR Act.

(Section 5.10)

**8.4.10 Review of AML/CFT**

The financial sector has been brought under purview of KYC/AML regime consequent to enactment of PMLA, 2002 and guidelines issued by respective regulators for entities regulated by them.

(Section 5.11.1)

The AML/CFT methodology 2004 is designed to assess the country's compliance with international AML/CFT standards contained in FATF 40 recommendations (2003) and FATF 9 special recommendations (2001). The present Report reviews the status of the assessment of Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) standards done by the Asia Pacific Group in 2005. The assessment by APG in 2005 has recommended among other things that PMLA should be brought in force, India should work towards full implementation of PMLA offences and encourage investigation/ prosecution in the area, money laundering in PMLA should be a stand-alone offence, PMLA offence should be in line with elements of offence in the Palermo Convention, FIU should be expressly authorised under legislation to obtain additional information from reporting parties and disseminate information to appropriate authorities for investigation, and amend PMLA to cover exchange houses and money remitters.

(Section 5.11.2)

Subsequent to assessment by the APG in 2005, a number of initiatives have been taken by the Reserve Bank, SEBI and IRDA to plug the gaps, like issuance of KYC/AML guidelines by the Reserve Bank to the co-operative sector, NBFCs and authorised FFMCs. Guidelines on CTR/STR and record keeping have been issued by the Reserve Bank to scheduled commercial banks, co-operatives and NBFCs. Guidelines on AML have also been issued by IRDA to life and non-life insurance companies. SEBI has also issued guidelines to securities market intermediaries to establish policies and procedures to combat money laundering and terrorist financing. The Reserve Bank has also taken penal actions against scheduled banks in the form of issuance of advisory and show cause notices, issuance of letters of warning and imposition of penalty. SEBI has also taken similar action against brokers and depository participants.

(Section 5.11.3)

The recommendations emanating from the present review are:

(i) Need to maintain written record of STRs.

(ii) Money transfer agencies need to be brought within the ambit of PMLA.

(iii) Need to make requisite amendments to PMLA Rules to make tipping off in the case of STRs a legal offence.

(iv) Suitable amendments need to be made to PMLA, whereby STR on attempted transactions are reported by various financial entities.

(Section 5.11.4)

## 8.5 Transparency Issues

### 8.5.1 Transparency in Monetary Policy

*Review of Legislations*

The objectives of monetary policy as evolved in practice over time fall within the ambit of overall objectives stated in the preamble of the RBI Act, *viz.*, 'to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability and generally to operate the currency and credit system of the country to its advantage.' The present legislative framework provides enough room and manoeuverability for the Reserve Bank to operate the monetary policy to meet evolving needs and circumstances. If the objectives are more stringently framed in legislation, it may not be possible for the Reserve Bank to adapt its policies flexibly, as necessitated by evolving circumstances. In the times ahead, without invoking the rigour of statutory rigidity, which will strait-jacket the Reserve Bank's policies, the current flexibility to determine the objectives and their relative importance, within and consistent with the meaning of the Preamble, will be a major factor in helping the Reserve Bank to conduct monetary policy successfully. Taking all these into account and also the fact that the Reserve Bank has been responding to policy needs in a flexible but fully transparent manner, the CFSA feels that, at the current juncture, significant changes to the statutory basis for refining monetary policy objectives may not be required and the current statutory provisions are flexible and clear enough for the Reserve Bank to define policy objectives and implement monetary operations to fulfill its objectives. Any rigid framework, explicitly incorporated in legislation or mandated otherwise, in the CFSA's view, would reduce this flexibility. However, one member of the CFSA felt that instead of multiple objectives, the Reserve Bank should primarily have the objectives of price stability, financial stability and growth.

To achieve its objectives, the RBI Act has provisions relating to the use of various instruments such as CRR, Bank Rate, Refinance facilities, Open Market Operations (OMO), including LAF and MSS. The Reserve Bank has

wide-ranging statutory powers of extending central bank money as the lender of last resort, including the power of direct discount in crisis situations. A recent amendment to the RBI Act in 2006 has clarified the powers of the Reserve Bank in regard to the use of the repo instrument and has provided more operational flexibility in determining CRR and SLR. Therefore, in the current circumstances, a review of the legislation, in the context of adequacy of policy instruments available to the Reserve Bank for achieving its objectives is not necessary.

Some objectives of monetary policy such as credit delivery, credit quality and financial inclusion require prudential measures and the related question is whether the Reserve Bank has enough powers to complement purely monetary measures with prudential measures as and when needed. In the context of the clarity of the role of the Reserve Bank as a regulator and supervisor, the Advisory Panel on Transparency Standards has observed that the responsibilities of the Reserve Bank in regulating and supervising entities like rural financial institutions, urban co-operative banks, chit funds and *nidhis* are not clearly specified in legislation. There is considerable overlap with the Government and other regulators in this area. The roles and responsibilities of the Reserve Bank as a regulator and supervisor may require clarification in the statute, as they are subject to considerable overlap with those of the Government and other regulators.

The regulatory and supervisory jurisdictions of the Reserve Bank have expanded, over time, through legislations as also a series of amendments to these legislations. The presence of the Government and the setting up of other regulators such as SEBI, IRDA and PFRDA have resulted in a situation where the regulators have come to acquire generally divided, but some overlapping responsibilities across institutions and markets. Despite the overlap, sufficient legislative authority is available with the Reserve Bank for discharge of its regulatory/supervisory functions. Though all of the Reserve Bank's powers are not derived from a single legislation, collectively there is no ambiguity about its role, functions and powers with institutions and markets. The Reserve Bank has also been given additional powers through amendments to the RBI Act as well as other legislations, and any need for additional powers may not need an overhaul of the present legislative framework, but can be addressed through amendments as required.

To address the remaining overlaps, a mechanism for inter-regulatory co-operation exists and this mechanism can be further strengthened in the context of maintaining financial stability and supervision over, particularly, the growing financial conglomerates.

It may not be possible to remove the overlap in financial regulation and supervision *vis-à-vis* the Government, as the roles of the government in this respect are based on the Indian Constitution. Acknowledging that grey areas exist in this particular area, the CFSA felt that they can be resolved through discussions/consultations, rather than through segregating responsibilities

into watertight compartments. Therefore, there is no further requirement for a thorough review of the RBI Act or other legislations for re-defining and clarifying the responsibilities of the Reserve Bank in regulation and supervision of various institutions. However, if necessary, further amendments could be considered to the BR Act to bring it in alignment with modern banking and financial practices.

The presence of representatives of the Reserve Bank on the board of the regulated entities may be avoided in normal circumstances, but they may be required to be placed on the boards in the case of re-structuring, moratorium and other exceptional circumstances emanating from weakness of the entities. Hence, the legal provision, as an enabling provision for the presence of such representatives, may be maintained.

The Reserve Bank enjoys *de facto* independence *vis-à-vis* the executive arm of the state through conventions, agreements and MoUs in specific areas, and has gained, over time, a greater degree of operational independence in performing its monetary policy function. The specification of procedure and reasons for the removal of the Governor/Deputy Governor as also for supersession of the Board could lead to a potential for loss of well-established *de facto* independence. Any modifications that might be required to strengthen the monetary policy as also the regulatory framework might be carried out by necessary amendments to existing legislations as needed, which would not call for a fundamental review of legislations or an overhaul of the existing legal framework. One member of the CFSA felt that though the system of achieving operational autonomy through *de facto* means rather than *de jure* means has worked well so far, situations might arise when the independence and autonomy of the Reserve Bank may be circumscribed by the executive. To guard against such eventualities, all the issues relevant for securing *de jure* independence of the Reserve Bank may be considered for formalisation.

(Section 6.2.31)

*Separation of Debt Management from Monetary Management*

The issue of conflict between the debt management and monetary management functions of the Reserve Bank has received considerable attention in the last ten years. Various Groups set up by the Reserve Bank have recommended separation of these two functions and hiving-off debt management function to an independent entity. Following the Budget (2007-08) announcement, the Central Government is proceeding with the

establishment of a Middle Office as a prelude to setting up a full-fledged Debt Management Office. The CFSA notes that the Government is in favour of proceeding with the setting up of a full-fledged DMO for the following reasons:

(i) With the passage of the FRBM Act, the basic source of conflict of interest has been removed. In the interest of prudent macro-economic and fiscal management, it is better for the Government to adopt a responsible fiscal policy and face the real market cost of funding;

(ii) The stipulations with respect to mandatory investment in 'SLR'(government) securities, helps the Government to finance its fiscal deficit at costs that are perhaps lower than they would otherwise be. These mandatory requirements could also inhibit the natural development of the bond market. As the economy and financial markets develop over time, such requirements can be expected to come down. Government debt issuance and management will then need more intense engagement with the market participants and with investors, in particular;

(iii) The issue of harmonising the functions of debt management and foreign exchange intervention in the interest of preserving financial stability can be addressed in the design of the DMO, by ensuring adequate, immediate and continuing channels of communication between the proposed DMO and the Reserve Bank;

(iv) The development of the securities market has to be a collective effort between the Government, and all the financial market regulators. Though, it can be argued that the two roles of providing price and financial stability and of developing markets should be separated, mixing the two roles can lead to inadequate or tardy development of the Government securities market;

(v) As far as staffing issues are concerned, the DMO can hire from the Reserve Bank and from the market; and

(vi) Competition may improve public debt management. The States should be given a choice of debt managers; they can remain with the Reserve Bank or move to the DMO.

While acknowledging that there could be potential conflicts in objectives and operations between debt management and monetary management and, therefore, for effective discharge of both, a functional separation could eventually be desirable, the Chairman personally felt that the time is not ripe for the complete separation of debt management from the Reserve Bank for the following reasons:

(i) With the high levels of fiscal deficit and debt, there will be a continuing need for ensuring overall consistency in fiscal and monetary management;

(ii) Until the consolidated fiscal deficit of the government comes down even further, enabling a reduction in the SLR, management of government debt, regulation of the banks and monetary policy will continue to be intertwined;

(iii) In a situation of volatile capital flows, foreign exchange intervention from the Reserve Bank is necessary on a relatively continuous basis. Separation of the DMO from the Reserve Bank will make it very difficult to harmonise these operations of sterilisation or otherwise, through MSS, as is done a present;

(iv) In the current Indian context where 70 per cent of the banking assets remain in the public sector banks, setting up of a DMO under the Ministry of Finance may exacerbate the conflict between government's role as a debt manager and its status as the owner of a substantial portion of the banking sector;

(v) Government's debt management requires further development of the government securities market through both institutional and market development activities. Thus, there is a continuing need for these activities to be co-ordinated by the Reserve Bank in such a way that monetary and financial stability is maintained along with such financial deepening in the government securities market;

(vi) Separation of the Central Government DMO will make harmonisation of Central and State Governments' market borrowing programmes difficult. Furthermore, it may not be appropriate for a Central Government authority to also do State Government debt management;

(vii) The setting up of a Middle Office in the Ministry of Finance to frame overall policies pertaining to debt management would facilitate an integrated approach to debt management. However, the Reserve Bank could continue to conduct all market borrowing operations as the agent of the government;

(viii) As a practical issue, it has always been difficult to set up new government authorities with respect to staffing of these institutions; and

(ix) The Reserve Bank is able to handle the debt management operations in view of the large size of its staff and expertise developed in managing regulation and supervision of the banks, money market operations and debt market operations. The staff of the DMO will need to be

conversant with financial markets and also be able to interact with market players continuously.

(Section 6.2.32)

*Other Issues Relating to Transparency in Monetary Policy*

Given the economic and demographic diversity that exists in India, a combination of different measures of inflation gives useful information on diverse aspects which is found to be meaningful in formulating an appropriate policy. Relying on a single index might result in loss of information regarding some crucial sectors and might be less useful in tackling the diversity of issues. Though price stability is a dominant objective of monetary policy, switching over to the CPI as an inflation indicator is not an immediate imperative. In India, many data-series such as unemployment rate, labour productivity, capacity utilisation, inflation expectations, housing prices and volumes are yet to be made available. The weekly WPI data give a feel of the economic dynamics with a shorter lag than the CPI. Until a system is in place to generate the above-mentioned data to help in monetary policy formulation, giving up the weekly compilation of WPI is not advisable.

The policies of the Reserve Bank need to be consistent with public policy and, where consultations with Government are needed, the existing formal and informal arrangements for consultations ensure that in practice the central bank is *de facto* independent. It would prove to be impractical to record such processes of consultations and it is also not desirable attempting to do so.

TACMP was set up with a view to strengthening the consultative process in monetary policy and keeping in mind that there may be a move towards collegial decision-making in future. The members of the Committee are not appointed on a full-time basis and as such they cannot be made accountable for decisions. Furthermore, unlike many inflation targeting countries, no particular decision like setting of a short-term interest rate rests with the Committee. The Reserve Bank achieves its objectives of monetary policy through a variety of measures and instruments like the CRR, open market operations, market stabilisation schemes and prudential measures, all of which form part of the monetary policy framework. As such, it may not be possible for members of the TACMP, who are not full-time members and hence not accountable, to vote on a single instrument or a measure to achieve the different objectives of monetary policy. The TACMP, as an institution, is relatively new (being less than four years old) and the Committee and its role have been evolving since its inception. However, there is a need for exploring possible avenues of further transparency in the operations of the TACMP and these are under active consideration in the Reserve Bank, which will be implemented when conditions are suitable. One way of further strengthening the TACMP could be by making the proceedings of its meetings public, even if it plays only an advisory role. Since there is neither voting nor a single decision-point like setting a targeted rate, the scope and need for wider

dissemination of the discussions leading up to such a decision is limited. The CFSA also apprehends that full publicity to the proceedings of TACMP could make members reluctant to express their views and opinions freely. However, the issue of making the discussions at TACMP public can be kept under consideration, and can be done at an appropriate time, when it is considered desirable. Under the current circumstances and given the ambit within which TACMP provides its advice, the need for strengthening the role of TACMP should be kept in view and practices/procedures towards this goal could be considered as it gains more experience.

The Reserve Bank has been making efforts to render the language of policy statements as lucid and comprehensible as possible so that all categories of readers of the document can understand the import of the rationale underlying the policy measures. However, the Reserve Bank should consider issuing a key to policy statements prepared in a simpler and less technical language.

The CFSA observes that the Reserve Bank has consistently been making it clear, as part of its periodic policy statements, that 'its exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene, if and when necessary.' The Reserve Bank's interventions in the foreign exchange market are only to contain excessive volatility. The CFSA views the policy on exchange rate management as transparently stated and consistent with current monetary policy objectives. However, one of the members added that the exchange rate management *per se* should not be an independent goal other than in the context of growth, price stability and financial stability, which should form the primary objectives of monetary policy.

(Section 6.2.2)

**8.5.2 Transparency in Financial Policies**

Most financial sector regulatory laws in India appear to be formulated in favour of transparency. In this regard, the laws governing the Reserve Bank, SEBI and IRDA are observed to provide the required degree of operational transparency. The provisions relating to criteria for removal of heads are more transparent in respect of SEBI and IRDA Acts. The findings regarding financial transparency practices were quite favourable. No significant weaknesses were identified with respect to banking supervision, securities supervision or

insurance supervision, while the shortcomings in the deposit insurance scheme were relatively minor.

(Section 6.3.3)

The development of new financial instruments, like complex derivative instruments, whose value, price and ownership are difficult to ascertain and new financial institutions, like hedge funds, private equity, and SIVs with little or no regulation have led to lack of transparency in financial markets. Lack of information and disclosure to both market participants and to relevant regulators has led to loss of investor confidence.

(Section 6.3.31)

The relationship between the main regulatory bodies is not defined in the statute, but the jurisdictional issues of the regulatory bodies are often disclosed in notifications published in the Official Gazette. At present, co-operation and information-sharing between the Reserve Bank and other regulatory agencies is handled by a formal standing committee, *viz.*, the High Level Co-ordination Committee on Financial Markets (HLCCFM). There is a need for achieving greater exchange of information between the regulatory agencies in the financial sector in a timely manner for maintaining systemic stability. However, further institutionalisation and formalisation of the existing co-ordination arrangements through the HLCCFM in a rigid fashion might turn out to be counter-productive, as they would take away the freedom and flexibility which are necessary for the formulation and implementation of financial sector policies. The CFSA, therefore, views the current arrangements as adequate since they have stood the test of time by maintaining systemic stability through inter-regulatory co-ordination, and no further stringent formalisation of arrangements would be necessary. What matters is the quality and knowledge of the regulatory authorities and not the institutionalised structure of the interaction between them. However, the CFSA recommends that modes of achieving greater exchange of information in a need-based and timely manner may be explored and put in place, as appropriate.

(Section 6.3.32)

As there is no system of disclosing aggregate data of emergency financial support by way of provision of liquidity (of the nature of LoLR) extended by the Reserve Bank to banks under exceptional and unforeseen circumstances, it would be appropriate from the organisational view-point and also from the transparency angle if such information is placed in the public domain after a suitable period. Since this practice is in place in many central banks, and has been advocated by the IMF as well, the CFSA endorses the view of the Panel, while emphasising that the data can be provided only on an aggregate basis with a suitable lag.

There is a lack of a formal dispute resolution mechanism in the government securities market. A formal dispute resolution mechanism may be put in place in the government securities market.

(Section 6.3.33)

SEBI, along with the stock exchanges and other regulators, should invest in technology to ensure that all the information they receive from the companies, market intermediaries (such as brokers), and mutual funds should be treated as public goods and disseminated in real time to the public without any privileges to any special bodies. Embargo for data releases, if any, should be for a specified time period and exceptions, if any, to this stance on information dissemination should be explained on the official website of the regulator.

(Section 6.3.34)

Internal governance and internal audit procedures of IRDA are at present not publicly disclosed. IRDA should consider placing this information in the public domain in line with the public disclosure of internal governance procedures and internal audit arrangements by the Reserve Bank and the SEBI through their respective Annual Reports.

(Section 6.3.35)

**8.5.3 Fiscal Transparency**

The Indian federal structure comprises three levels of government, *viz.*, Centre, States and local bodies. The functional responsibilities and *inter se* relationships among different tiers of governments are governed by constitutional provisions. Fiscal transparency is significantly observed both in the Centre and States. Also institutional developments, particularly of the enactment of Fiscal Responsibility and Budget Management (FRBM) legislations by the Central Government in 2003 and by 26 out of 28 State Governments between 2002 and 2007, have significantly contributed to greater fiscal transparency since the ROSC in 2001. But, overall, the current status of compliance still leaves room for the substantial improvement that is needed for greater transparency.

(Section 6.4.3)

While the Constitution clearly demarcates functions between the Centre and States and areas where they hold concurrent responsibility, in practice, the Panel has observed that functional overlap by the Central Government on the functional domain of States in important spheres, like health and agriculture, has led to a deterioration in the quality of governance, hampering timely responses to external shocks, and negates the purpose of defining separate spheres of responsibility. Such functional overlap needs to be minimised or properly institutionalised so that the roles of the Central and State Governments are clearly defined in practice and accountability is

appropriately established. The intention is not to redefine the constitutional provisions, but to restore the provisions without distorting the functional demarcation.

At present, there is no independent institutional set-up to look into the implementation of Finance Commissions' recommendations. A clear channel needs to be established as part of the implementation process of the Finance Commission's recommendations. For enhancing transparency of Finance Commission awards, the revenue-sharing calculations must be placed on the website.

While States are required to establish State Finance Commissions (SFCs) every five years to examine the transfer and devolution of resources from States to local bodies, the SFCs are not regularly appointed by the States. All States should set up SFCs, ensure timely submission of Reports and report compliance with rationale for rejecting any of the recommendations.

Many times, cover for losses of State PSUs is extended through equity contributions from the capital account, instead of subsidies through the revenue account. Such non-transparent transactions need to be curbed.

A common reporting framework for compensation and assignments to local bodies applicable to all States should be developed. Transfers of funds devolved to local levels should also be reported separately for rural and urban local bodies.

(Section 6.4.31)

On contractual arrangements, there are sometimes long delays by Governments in honouring payments to various entities (including inter-government) and individuals. Time-limits for payments should be honoured and there is a need to formally include such provisions as part of legal contracts along with suitable recourse mechanisms. Payments should be tracked down the line on an IT platform.

Tax assessees lack information on completed assessments and payment of refunds can be considerably delayed. All tax assessees must be informed of the initial assessments, accompanied by refunds/additional tax demand within a period of, say, six months. Timely settlement of appeals from tax-payers needs to be improved.

Public-private partnership (PPP) documents should include time-limits within which payments should be honoured.

State Governments, as a general rule, do not provide economic and functional classifications of expenditures annually in a systematic manner. This is necessary, though a time lag of about six months after the budget may be permissible.

(Section 6.4.32)

There are discrepancies in the reporting of liabilities and deficit in, particularly, borrowings by PSUs and there is scope for improvement in

transparent fiscal reporting on these matters. Governments must make efforts to provide this data. State Governments should provide data on contingent liabilities in a uniform manner; also, the data relating to debt should provide a break-down according to instruments, maturity pattern and repayments falling due.

In order to sort out the discrepancies in fiscal data reported by various data disseminating agencies, a Working Group needs to be set up to address this issue. The Group should also analyse the reasons for such discrepancies, which could be related to aspects such as consistency in definition, approach or time lag.

The mode of calculating the fiscal deficit fails to capture the impact of off-budget items or provide such figures separately. The gross fiscal deficit reported in the budget document needs to be accompanied by an augmented fiscal deficit to capture off-budget items, such as oil bonds, FCI bonds and fertiliser subsidies.

(Section 6.4.33)

The budget documents do not cover the actual audited expenditure statement which comes out with a lag of about 6 to 9 months. Efforts should be made by both Central and State Governments to reduce this time lag and increase the frequency of financial disclosures. Expenditure on all government-funded schemes with descriptions of what they propose to achieve should be available on a yearly basis, with progressive actual expenditure on each scheme. Currently, these details are available in the Annual Reports/Outcome Budgets of separate Ministries to which the schemes pertain. However, comparable time-series information should also be made available for the preceding years, so that monitoring yearly actual expenditure on these schemes is not difficult.

The purpose of budgetary heads and sub-heads is to categorise public expenditure such that the composition of public expenditure becomes transparent. The budgetary structure in India has evolved by accretion over time and does not at present adequately convey the functional content of each budget head category. A Working Group to restructure and rationalise the budget head structure for reporting expenditures should be appointed. The revised budget head structure should be made binding on all Governments. However, the issues relating to budget head structure could be first referred to the CAG before setting up the Working Group.

The recommendation of the Twelfth Finance Commission for moving over from cash-based accounting towards accrual-based accounting was in-principle accepted by the Government. CFSA agrees that accrual-based accounting, to a great extent, removes shortcomings on account of limitations of cash-based accounting distorting the fiscal reporting. At the same time, it recognises that switching over to accrual-based accounting is not a simple or easy task and requires huge investments in skill development. There are also serious problems of tackling information that may not be easily available.

The CFSA, therefore, recommends that there should not be any hasty move towards accrual-based accounting and it should be treated with extraordinary care and caution and attempted in phases only after preparing a strong ground in terms of skills and awareness at all levels. The CFSA also endorses the view of the Advisory Panel that such a move has to be phased in such a manner that there is no confusion or disruption of time-series on important fiscal indicators. There has to be a well-planned transition, with officials at Central and State-levels who are well-trained in the new accounting system. The CFSA hastens to add that this should not preclude the Governments from removing serious distortions caused by cash-based fiscal reporting on account of factors such as deferment of payment of subsidies through issue of bonds.

(Section 6.4.34)

The CFSA notes that with fiscal responsibility legislations in place, the monitoring and reporting of fiscal indicators has enormously improved. The Central Government sets forth a three-year rolling target for prescribed fiscal indicators with broad specification of underlying assumptions. These are set out in the Medium-term Fiscal Policy Statement laid down with the Union Budget. These could, however, be further enhanced by providing sensitivity analysis for fiscal projections with respect to the underlying parameters assumed. Similarly, FRLs in general make State Governments more accountable and transparent, with provisions for quarterly/half-yearly fiscal reviews and setting up of an independent agency to review the compliance provisions of the Act. However, there is need for sensitivity analysis of fiscal forecasts and quantification of fiscal risks.

The Reserve Bank has been publishing data on the combined government finances of the Centre and State Governments as per the IMF's SDDS. While the Central Government reports its finances for the IMF publication *Government Finance Statistics (GFS)*, there is no reporting of State Government or combined government finances in the GFS. The CFSA recommends that progress in this regard should be made in the medium-term, along with the phased introduction of accrual-based accounting. The Reserve Bank should continue to compile and publish, as per the present SDDS requirements, the general government public finance statistics within six months of the end of the reference year.

Fiscal marksmanship at the State-level needs strengthening, so that budget expenditure estimates do not exceed the known feasible limits.

Several other issues have also been raised regarding the dissemination of fiscal data, monitoring and reporting.

The public capital outlay in any state is an aggregate of State Government-funded outlays and outlays funded directly by the Central Government which are not all routed through the State exchequer, and can either be spent directly by line outposts of the Centre, or through sub-State-level agencies, or through local governments. Though the office of the CAG compiles the combined Finance Accounts for the Central Government and State Governments, there is a significant time lag in the availability of information in view of the time lag in finalisation of State Accounts. There is no ready source of data on this aggregate, which makes the public capital outlay in a State impossible to quantify. The CFSA recommends that the Working Group on budget heads should address this issue specifically.

Disinvestment receipts are officially provided only at the central-level; there are no source records of disinvestment receipts in aggregate across States. The CFSA strongly recommends that this be resolved.

Local bodies' own revenues and expenditures are becoming sufficiently important that there should be a systematic provision for collection of data on these. The only sources so far have been the Reports of the National Finance Commissions, starting with the Eleventh Finance Commission, but the revenue data reported there seem to be inflated, from the evidence of sample survey-based studies. The CFSA recommends that this needs to be streamlined. The Working Group for resolving discrepancies in fiscal reporting may address this issue as well.

(Section 6.4.35)

### 8.5.4 Data Dissemination

While India is largely compliant with the IMF's Special Data Dissemination Standards and exceeds the requirements under the code in several areas, there is an urgent need to strengthen the major official data collection agencies in the country, *viz.*, the CSO in the compilation of national accounts statistics and Index of Industrial Production; the Central Government in the compilation of labour market data and price indices; and the Government and the Reserve Bank in the compilation of balance of payments data, fiscal data and lead indicators.

Prior to liberalisation, statistical data were obtained by government agencies through the powers and authority granted to the administrative machinery by various legislations. With the reform process initiated since the early 1990s, data collection for administrative requirements has weakened and data submission is mainly voluntary. There has also been significant expansion in the role of the services sector in the economy, whose data is not adequately captured at present. There is, therefore, a need for a collaborative arrangement between the Centre and State Governments in generating accurate and reliable industrial data. The quality of the agricultural data has also deteriorated with the weakening of the land revenue system and the consequent unreliability of the estimates of land use. There is also a need to supplement national statistics with State-level statistics, which would allow comparable analyses of economic problems and performance at the State-level. There is also a need for co-ordination between the CSO and the Central ministries involved in data collection as also between the state statistical bureaus and the ministries in the States.

(Section 6.5.4)

*Central Statistical Organisation (CSO)*

A large number of independent ministries, departments and local agencies provide the CSO with the requisite information for the compilation of the national accounts statistics (NAS). With liberalisation and reforms, several of the traditional links that compiled and provided statistics to the CSO have deteriorated. The legal and institutional environment of national accounts statistics, as brought out by the National Statistical Commission, continue to remain weak. Generally, the accuracy and reliability of the expenditure side of the GDP is much lower than that of the production side. There is a need to substantially improve the accuracy of the expenditure-side statistics of the national accounts. CSO needs to be strengthened to ensure that the generation of the national accounts is well-supported by the legal and institutional environment it merits.

Changes in methodology in the compilation of NAS are not easily available in the public domain. It would be useful if the CSO made all material, pertaining to changes in methodology, automatically available on its website.

There are several gaps in the statistical techniques used by the CSO. CSO's statistical techniques need greater independent review so that the CSO could make appropriate changes in its techniques. Advance notice may also be given for major changes in methodology, source data and statistical techniques. CSO may study and analyse its revisions and make such studies public to help users understand the revisions better.

As in the case of national accounts, with liberalisation (de-licensing in particular) the institutional data collection machinery has suffered in the compilation of IIP. CSO should assume direct responsibility for the generation of IIP. It should create the frame, select the sample and collect the data directly

from the units. In the process of consolidation of the source agencies, CSO should reduce its reliance on the administrative machinery and industry associations and strengthen its own direct capabilities. The CSO can further improve the transparency of the IIP if it also reveals the size (number) of units in the frame, the sample size and the monthly response rate for each item of the IIP. The IIP needs to adjust its basket of commodities and the weights assigned to these quicker than it currently does. The IIP excludes construction, gas and water supply but the United Nations Statistical Office recommends their inclusion; it would be useful if the scope of the IIP were expanded to include construction, water supply and gas sectors. The publication of the response rate with each release would also enable users to anticipate changes in the estimates and appreciate the revisions when they occur.

While CFSA appreciates the merits in moving towards a chain-linked index instead of a base-linked index in the compilation of IIP and price indices, given the fast-changing commodity sector profile due to modernisation and new technology, the full implications of the change in terms of coverage, consistency and continuity in time-series must be examined by the Government before implementation.

(Section 6.5.41)

*Central Government*

There are multiple agencies involved in the measurement of employment, unemployment and wages in India. In spite of a proliferation of agencies, there is no single comprehensive and reliable estimate of any of the three basic measures of labour markets – employment, unemployment and wages – on a regular basis with an acceptable periodicity or timeliness. The fragmented efforts in the compilation of statistics relating to the labour markets should be consolidated under one institution that is adequately empowered to undertake this task comprehensively and effectively. The CSO, as the premier statistical agency of the country, is the most appropriate agency to undertake this responsibility with the help of the National Sample Survey Organisation (NSSO). It would be ideal if such new efforts were made in a manner such that it also conforms to the standards in the DQAF.

Statistics should be compiled by professional statistical agencies that deploy appropriate statistical methodologies rather than by the administrative arms of the Government through voluntary or statutory compliance of legislations.

As regards price data, India meets the requirements in terms of coverage, periodicity and timeliness for the price indicators for SDDS

comprehensively. The WPI is more transparent than the CPI-IW because it provides index numbers for individual items in the overall index. However, the WPI provides only the index and not the price. This limits the utility of the WPI. In the interest of increasing the transparency and application of the WPI, it should also reveal the prices underlying the creation of the indices.

The choice of sources in compiling the price indices is based largely on operative convenience arising from using the administrative machinery. There is scope to improve upon this selection as, in several markets, sophisticated systems have been established to collect reliable price estimates of commodities. This is particularly true in the light of the establishment of several commodity futures exchanges. The agencies that collect prices to measure inflation also exploit these new sources.

The Labour Bureau, in the generation of the CPI-IW, and the Office of Economic Advisor, in the generation of the WPI, should improve their transparency substantially by revealing the number of respondents in the frame, the monthly response rates, the revision in the responses and the policies they follow with respect to revisions. This information may also be made public for a fair assessment of the credibility of the price indices.

The WPI suffers seriously from outdated weights. Infrequent updating of weights leads to the use of outdated weights in the indices. It also often excludes new products for the same reason. There should be frequent updating of weights in the compilation of WPI.

(Section 6.5.42)

*Reserve Bank of India*

India does not provide any forward-looking indicators. The Reserve Bank conducts quarterly surveys on capacity utilisation and order-book positions. These could be used to develop a full set of forward-looking indicators and disseminated.

(Section 6.5.43)

There is no formal law or arrangement assigning responsibility for the collection, processing and dissemination of data relating to balance of payments with the Reserve Bank. Most of the information obtained is a bye-product of reporting of foreign exchange transactions by Authorised Dealers. Thus, data collection is a function of the regulations in force and is vulnerable to possible changes in the future. Data collection may suffer as it did in the case of the IIP and the WPI. Arrangements could be made by the Reserve Bank so that the data are collected through a more professional and sustainable system.

(Section 6.5.43)

## 8.6 Development Issues in the Socio-Economic Context

Bank nationalisation in India marked a paradigm shift in the focus of banking from class banking to mass banking. The co-operative sector and RRBs are other major conduits in the banking sector to promote financial inclusion.

Post offices are another major institution providing bank-like facilities to the less affluent segment of the population. There is a need to expand the access of insurance to the rural and urban poor. However, the dependence on non-institutional sources of finance continues to be evident in respect of poorer households within the income bracket of less than Rs.25,000.

(Section 7.2.2)

While the recent Financial Development Index 2008 Rankings by the World Economic Forum (covering 52 countries) has ranked India at a high 10th in respect of ease of access to credit and ease of access to the local equity market, there is significant scope for improvement in areas relating to financial inclusion.

(Section 7.2.31)

The focus of financial inclusion in India has progressed from ensuring bare minimum access to a no-frills savings bank account for the unbanked population to the concept of 'Total Financial Inclusion'. This involves meeting the entire credit requirements of Self-Help Group members, *viz.*, (a) income generation activities, (b) social needs like housing, education, and marriage, and (c) debt swapping. Banks were allowed to adopt the agency model known as the Business facilitator/Business Correspondent model for achieving greater outreach through intermediaries/agents. In order to promote credit to the agricultural sector and rural and semi-urban areas, banks have been permitted to introduce Kisan Credit Cards (KCC) and General Credit Cards (GCC), which are issued based on an assessment of the income and cash flow of households. Some of the other initiatives taken in this regard are self-help groups, micro-finance institutions and e-choupals.

(Section 7.2.32, 7.2.33 and 7.2.35)

The entire gamut of recommendations of the Rangarajan Committee on Financial Inclusion would need to be reviewed and implemented in a phased manner so as to promote and achieve financial inclusion.

(Section 7.2.41)

Exploitation of synergies between local financial institutions with national level financial entities would help achieve greater financial inclusion. Financial inclusion can be enhanced through the introduction of products tailored to the needs of small borrowers. In order for such initiatives to be successful, there is, however, a need to imbibe a credit culture among the unbanked population, especially in semi-urban and rural areas by creating a conducive climate for the same.

(Section 7.2.44)

IT-enabled banking services have the potential to effectively meet the challenge of reaching out to financially excluded customers, especially in rural areas. Banks should scale up IT initiatives for financial inclusion at a greater speed, while ensuring that solutions are highly secure, amenable to audit, and follow widely-accepted open standards to ensure eventual inter-operability among the different systems.

While introduction of biometric smart cards in rural areas is a welcome step in order to enhance financial inclusion, the process needs to be looked at from a holistic perspective, taking into account both risks and returns in the interests of its long-term viability. Initiatives to migrate from smart cards to a cardless process, which is expected to control costs, could be encouraged.

Suitably incentivise the business correspondents (BCs) to popularise the process by making them aware of intangible synergies, taking into account both risks and returns from a longer-term perspective.

Mobile banking services are gaining popularity in micro-payment scenarios by extending financial services through virtual accounts and have the potential to significantly lower transaction costs, while expanding outreach to rural areas. However, key challenges in developing a mobile banking system include the lack of standardisation, the security aspects of financial transactions being executed through mobile telephony and the transmission of financial information. The Reserve Bank had placed a paper on mobile banking in the public domain and has recently introduced a set of operating guidelines on the same for banks.

(Section 7.2.45)

Urban India has a huge poor migrant population, which is denied basic banking facilities. For them to be provided banking services, KYC norms may be required to be further diluted. In order for banks to be effective conduits for achieving the goals of financial inclusion, household and consumption expenditure would also need to be financed by banks to avoid non-institutional sources of borrowing.

(Section 7.2.46)

There is frequent circumvention of the Reserve Bank's guidelines in the area of financial inclusion. The banking sector considers advances made to poor sections unviable. There is a requirement to grant operational flexibility to banks to fix interest rates, reduce costs, enhance their risk assessment capabilities and provide better flow of credit information to credit information bureaus.

(Section 7.2.47)

Financial literacy and awareness needs to be taken up in a big way. With the objective of mainstreaming the activity of money lending as also strengthening the synergies between the formal and informal segments, the model legislation suggested by the Technical Group to Review the Legislation on Money Lending (2007) needs to be implemented.

It could be explored whether banks may be assessed on their performance relating to financial inclusion and rated accordingly. The Government has an important and crucial role in assisting financial inclusion through strengthening the rural infrastructure and facilitating the production and distribution of output.

There is a need for the lender to have in place appropriate credit risk mitigation techniques and take into account aspects related to security concerns and fraud prevention.

There should be a provision to provide adequate safety nets to banks for such functions in the form of a credit guarantee corporation.

State-level Bankers' Committee (SLBC) may be required to examine areas where physical location of branches is required and State Government should provide assistance to banks in opening branches at these centres.

(Section 7.2.49)

*Access to finance by small scale industries (SSIs)*

Despite their dominant numbers and importance in job creation, SSIs have traditionally faced difficulty in obtaining formal credit or equity. Commercial banks have a tendency to prefer large corporate borrowers, who provide better business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the banks.

Lending institutions must improve their ability to provide financial services to SSIs through commercial mechanisms that lower costs and minimise their risk exposure. Reducing the transmission cost of evaluating SSI credit could be a way of levelling the playing field.

(Section 7.3)

*Customer Service*

In spite of various initiatives to improve customer service, there are gaps in implementation of guidelines which give rise to customer grievances. Lack of appropriate and efficient information dissemination channels between the banks' head offices and their corresponding branches often leads to inadequacies in service. Limited awareness of customer rights is another area which needs to be addressed. Offering customised solutions to diverse customer groups remains a challenge in India. Customer service by banks could therefore be improved through measures like financial education, credit counselling and improvement in information dissemination.

Developing a database of customers is the bedrock on which banks can develop value-added customer service. While there is a need for developing of customer databases by banks to tailor products and services in line with customer needs, the risks associated with maintaining the confidentiality of such data and the possibility of identity theft need to be addressed through proper control mechanisms.

There has been an ongoing debate on the choice between a statutory regulation and self-regulation for oversight of customer service. As long as the basic principles for treating customers fairly like transparency, reasonableness, integrity in selling, confidentiality, assistance when needed, and effective grievance redressal machinery are being followed, whether a statutory or self-regulation is followed is not material to achievement of the desired objectives.

(Section 7.4)

*Sustainability Issues*

Sustainability combines environmental, social, ethical and governance factors. It defines business excellence, innovation and the licence to operate as a financial institution. Banks need to develop a culture of Socially Responsible Investing (SRI).

(Section 7.5)

## Major Recommendations of Previous Committees[160]

## 1. Banking System

### 1.1 Report of the Committee on the Financial System – Narasimham Committee (1991)

*Control of banks*

- Duality of control over banking system between the Reserve Bank and Banking Division, Ministry of Finance should end and the Reserve Bank should be the primary agency for the regulation of the banking system.

*Structure of banking system*

- The banking system should evolve towards a broad pattern consisting of (a) 3 or 4 large banks (including SBI) which could become international in character, (b) 8 to 10 national banks with a network of branches throughout the country engaged in universal banking, (c) local banks whose operations would be generally confined to a specific region, (d) rural banks (including RRBs) whose operations would be confined to rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities.

*Branch Licensing*

- Branch licensing should be abolished and the matter of opening or closing of branches (other than rural branches) be left to the commercial judgement of individual banks.

*Appointment of CMD of banks*

- Professionalism and integrity should be prime considerations in determining the appointment of CMD and boards of banks and while formal appointments have to be made by the Government, they should be based on the convention of accepting the recommendations of a group of eminent persons who could be invited by the Governor, Reserve Bank to make recommendations for such appointments. As regards board of PSBs and institutions, as long as the Government owns banks it would be necessary to have a Government direction to take care of proprietorial concerns, but there is no need for the Reserve Bank to have its representative on the bank's Board.

[160] Recommendations which are identified as pending, have been included, categorized into major themes addressed by the CFSA

## 1.2 Report of Committee on the Financial System - Narasimham Committee (1998)

*Asset quality, NPAs and Directed credit*

- There should be no further recapitalisation of banks as it involves budgetary commitments and could lead to large measure of monetisation.
- Directed credit has a disproportionately high share in the NPA portfolio of banks; hence, while there is a continuing need for banks to extend credit to agriculture and the small-scale sector which are important segments of the economy, it could be done on commercial considerations and on the basis of credit worthiness.

*Prudential norms and disclosure requirements*

- The income recognition and asset classification and provisioning norms should apply even to government guaranteed advances in the same manner as in the case of other advances. (Currently done in the case of State Government guarantees from July 2007).
- As an incentive to banks to make specific provisions, there is a need to make such provisions tax-deductible.

*Systems and methods in banks*

- There is need to introduce a system of recruiting skilled manpower from the open market in the case of public sector banks. Banks have to top up their skill base by resorting on an ongoing basis to lateral induction of experienced and skilled personnel particularly for quick entry into new activity/ areas. There has been a decline in the scale of merit-based recruitment even at the entry level in many banks, which needs to be reversed. There is no need to continue the Bank Service Recruitment Board (BSRB) insofar as recruitment of officers is concerned. As regards clerical recruitment, a beginning should be made in this regard by permitting three or four large well-performing banks like SBI to set up their own recruitment machinery for recruiting clerical staff. If the experience is satisfactory, it could pave the way for eventually doing away completely with the BSRB.
- The issue of remuneration structure at managerial levels in PSBs needs to be addressed. There is an urgent need to ensure that PSBs are given flexibility to determine managerial remuneration levels taking into account market trends. The necessary authority in this regard could initially be given to the Boards of banks in the case of profit-making PSBs which have gone public as they would be required to operate with accountability to the market.
- The tenure of the Chief Executive of the bank should be not less than five years; to begin with, it could be three years. There is need to delink the pay scales of Chief Executives of PSBs from civil service pay scales

and it should be left to be decided by individual banks, not excluding performance-based remuneration. These observations and recommendations also apply to whole-time directors on the Boards of the banks appointed by the Government.

- The management of Indian banks needs to review the changing training needs in individual banks, keeping in mind their own business environment, and to address these urgently.
- There may be a need to redefine the scope of external vigilance and investigative agencies with regard to the banking business. External agencies should have the requisite skills and expertise to take into account the commercial environment in which decisions are taken. A separate vigilance manual needs to be prepared which captures the special features of banking. Banks should put in place a system where a record of all credit decisions made by an individual officer together with his successful performance is maintained.

*Structural issues*

- Mergers of PSBs should emanate from managements of banks, with the Government as the common shareholder playing a supportive role. Mergers should not be seen as bailing out weak banks. Mergers between strong banks/FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of its parts and have a force multiplier effect.
- The minimum stipulations for government holding in the case of PSBs should be reviewed. The minimum shareholding by the Central Government/Reserve Bank in equity of PSBs should be brought down to 33 per cent to restore autonomy in functioning of banks. The appointment of a CMD should be left to the Boards of banks and the Boards themselves left to be elected by shareholders.

**1.3 Report on Observance of Standards and Codes – Corporate Governance – (2004)**

*Corporate Governance in Banks and DFIs*

*Separation of office of CEO and MD*:

- The Reserve Bank could consider drawing draft legislation for consideration by the Government. The Central Government may consider implementing the legislative changes.

- Boards should set up Remuneration Committees made up exclusively of non-executive Board members. The Reserve Bank wrote to the Central Government in June 2002 for DCA to consider the matter of legislative changes. The Reserve Bank and the Central Government may follow up on this.

**1.4 Report of the Advisory Group on Basel Core Principles (2001) and Review of Recommendations (2004)**

- The powers of the Reserve Bank to decide on capital requirements on a case-by-case basis needs to be clearly defined in law. The Reserve Bank could consider its legal, institutional and regulatory aspects in the context of discriminatory capital charge for proper risk management.
- A stricter view on objectives, philosophy and internal controls at pre-licensing stage, evaluating Directors on Board and making individual Directors accountable.
- Banks' risk management policies and procedures should be provided in publicly available documents.
- The Reserve Bank may consider introducing meetings with banks' boards and external auditors. It should enhance the role of external auditors.
- In the case of internationally active banks, MoUs with host country supervisors should be considered.
- The quality of corporate governance should be same for all types of banks; make Boards accountable and streamline the process of induction of Directors; steps for percolation of strategic objectives and values.
- Establishment of compensation committees to link remuneration/ rewards to contribution.
- Level of disclosures to be gradually improved. Detailed discussions on operational, legal and strategic risks may be made mandatory in the director's report to shareholders.
- The Reserve Bank should ensure fitness for directors/ managers of the unregulated entities in a conglomerate.
- Make arrangements for applying fit and proper tests on all shareholders with shareholding beyond a specified threshold (currently this exists only for private sector banks).
- Information sharing on parent bank's difficulties. Information on parent bank's difficulties is not being obtained.

***1.5 Report of the Committee on Fuller Capital Account Convertibility (2006)***

*Regulation and supervision issues in banking*

*Strengthening banking system*

- The minimum share of the Government/ Reserve Bank in the capital of public sector banks should be reduced from 51 per cent (55 per cent for

SBI) to 33 per cent as recommended by the Narasimham Committee on Banking Sector Reforms (1998). There are, admittedly, certain social objectives in the very nature of public sector banking and a reduction in the Government/ Reserve Bank holding to 33 per cent would not alter the positive aspects in the public sector character of these banks.

- In the first round of setting up new private sector banks, those private sector banks which had institutional backing have turned out to be the successful banks. The authorities should actively encourage similar initiatives by institutions to set up new private sector banks.
- Until amendments are made to the relevant statutes to promote consolidation in the banking system and address the capital requirements of the public sector banks, the Reserve Bank should evolve policies to allow, on a case-by-case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage non-banking finance companies to convert into banks. After exploring these avenues until 2009, foreign banks may be allowed to enhance their presence in the banking system.
- Issues of corporate governance in banks, powers of the Boards of public sector banks, remuneration issues, hiring of personnel with requisite skills in specialised functions and succession planning need early attention.
- The voting rights of investors should be in accordance with the provisions of the Companies Act.
- Following the model of the comprehensive exercise undertaken on transparency, a number of Groups/Committees could be set up for examining each set of issues under the overall guidance/coordination of a High Level Government – RBI Committee to ensure concerted and early action to expeditiously prepare the financial system to meet the challenges in the coming years in the context of Basel II and the move to FCAC. As part of this comprehensive exercise, the proposed Committee should revisit the issue of investments by foreign banks in Indian banking. In this Committee's view, this has relevance in the context of issues relating to bank recapitalisation, governance, induction of technology and weak banks.

*Liquidity risk*

- Liquidity position should be monitored at the head/corporate office level on a global basis, including both at the domestic branches and

foreign branches. It should also be monitored for each currency where the total liabilities in that currency exceed a stipulated percentage of the banks' total assets or liabilities

- Banks should be required to fix internal limits on the positive mismatches in the medium-term and long-term time buckets – say from 3 to 5 years and more than 5 years. This will ensure that banks do not assume large mismatch positions whereby they depend heavily on short-term resources for long-term deployment. These mismatch limits should be monitored by the Reserve Bank to look for outliers and initiate appropriate remedial measures.
- The Reserve Bank may consider prescribing tolerance levels for mismatches in the medium and long term. The Reserve Bank may introduce capital requirements for banks with reference to the degree of their maturity mismatches.
- Banks should continue to monitor the liquidity positions territory-wise where there are restrictions on the free movement of funds to/from other territories.
- The Reserve Bank should examine the need for a limit on the short-term borrowings (less than one year) of banks.

*Interest rate risk*

- The Reserve Bank should introduce capital requirements for banks with reference to the extent of IRR assumed by it and the likely impact of such risks on the bank's net worth during stress situations.

*Foreign Exchange open position*

- The Reserve Bank should consider reviewing the process for approving open position limits and consider issuing prudential limits for open position limits which will be linked to the bank's capacity to manage the foreign currency risks and their unimpaired Tier I capital funds.

*Asset concentration*

- Though banks have been advised to fix internal limits for substantial exposures by the Reserve Bank in October 1999, many banks are not adopting the limits. Hence, the banks should be directed to monitor their large exposures (*i.e.*, exposures in excess of 10 per cent of capital funds) and ensure that the aggregate of these exposures do not exceed a substantial exposure limit, *i.e.*, the sum of the total of all large exposures not to exceed a specified multiple of capital funds, say 600 per cent to 800 per cent.
- The Reserve Bank may fix a regulatory umbrella limit on sensitive sector exposures with relation to the bank's net worth/capital funds. The umbrella limit can be in addition to sector/exposure-specific limits like the capital market exposure limits. The Reserve Bank should

periodically identify sensitive sectors and review the need for fresh inclusion or exclusion of certain sectors.

*Income Recognition Asset Classification and Provisioning norms*

- The Reserve Bank should require banks to make provisions for their non fund-based commitments in NPA accounts with reference to credit equivalent amounts. The Reserve Bank should consider prescribing explicit conditions/situations when the banks should make a higher level of provisions for contingent liabilities.
- The Reserve Bank should re-introduce the concept of uniform asset classification across the banking system such that if an exposure to a counterparty becomes NPA in any bank, all banks having an exposure to that counterparty should classify the exposure as NPA.
- The Reserve Bank should review the schedule of provisioning requirements for NPAs and consider tightening the provisioning requirements. The provisioning requirements on sub-standard assets may be increased to 20 per cent for secured advances and 30 per cent for unsecured advances.

*Capital adequacy*

- It will not be adequate to have a uniform 9 per cent norm for all banks. The system should move forward to a differential capital regime. The '*complex*' banks (those that are diversified into areas other than conventional banking, are part of large group/financial conglomerate, undertake significant cross border transactions, act as market makers and are counterparties to complex transactions) should be moved over to this regime in the next three years and all other banks may be moved over to this regime over the next five years.
- Banks should be encouraged to migrate to an economic capital model for allocation of capital and measuring efficiency of capital. This may be dovetailed with the Pillar II requirement under Basel II which requires banks to have in place an internal capital adequacy assessment process (ICAAP).
- Consider introducing a higher core capital ratio (than the default 50 per cent of total capital funds) at present. It may be raised to at least 66 per cent.
- At present the banks generally do not adopt risk-based pricing. Further, almost 90 per cent of banks' credit portfolio is unrated. The risk weight

structure under Basel II provides a perverse incentive for high-risk borrowers to remain unrated. In view of this and since the system may not be able to rank risk objectively, the riskweighting system should be modified to reflect the actual economic risk undertaken by banks. Hence, unrated or high risk sectors should be subject to 150 per cent or higher risk weights.

- Systems for ongoing scientific valuation of assets and available collateral should be established, since in many banks these systems are conspicuous by their absence.
- A framework linking branch authorisations and undertaking new financial services to quality of capital and adequacy of capital should be established.
- Banks should not be allowed to carry accumulated losses in their books. They should be required to set off losses against capital funds, including certain capital instruments other than equity shares, on an ongoing basis. The Reserve Bank should decide on the methodology for setting off losses against capital funds.

*Level of Computerisation and Branch Interconnectivity*

- Going forward, the level of computerisation and branch interconnectivity will be of significant importance to banks. The quality of MIS will make a significant difference to banks' capabilities. A few banks are attempting to achieve this through their core banking solutions. Whatever be the mode banks should strive to achieve:

  (a) On-line connectivity to all major branches (75 per cent of business within 3 years and 90 per cent within 5 years and 100 per cent within 7 years).

  (b) MIS content should support the risk management requirements and supervisory reporting requirements.

*Need for Prudential Limits on Off-Balance Sheet (OBS) Items*

- In the absence of advanced risk management systems in banks, the risks that are assumed by them through the derivatives book can be a cause for worry. The Reserve Bank should study the composition of the off-balance sheet business of banks and consider issuing prudential norms establishing a linkage between the off-balance sheet business of banks and their risk management systems. They may also take into account international practices in this regard. With a view to reduce the time lag, the supervisory reports should be system-generated with appropriate authentication and submitted to the Reserve Bank using the IT medium.

*Off-balance sheet Exposures – Comfort Letters*

- The commitments undertaken through off-balance sheet items in the form of comfort letters are not reckoned at times. This might pose an

additional threat. Banks issue comfort letters in two situations: (i) covering operations of their subsidiaries to regulators in the host country; and (ii) comfort letters on behalf of their customers. Banks should reckon exposures assumed through such comfort letters also and have appropriate strategies in place to:

- Ensure that such contingencies do not arise – by ensuring that the operations for which comfort letters have been issued are always well managed and solvent.
- Have contingency plans in place to ensure that they are able to meet the demands as and when made without any serious disruption of overall operations.
- Make appropriate disclosures with regard to the nature and extent of comfort letters issued by them.

*Type of Supervision*

- The Reserve Bank should consider strengthening its supervisory framework, both off-site and on-site, to effectively capture the revised elements proposed above. The scope and focus of the revised supervisory framework may apply equally to both domestic branches and foreign branches.
- Supervision should be geared to assess the adequacy and effectiveness of the risk management systems in place in banks. The risk management systems in banks may be required to explicitly address all material risks and at the minimum should address the following risks: credit risk; market risks; operational risk; liquidity risk and country/ transfer risks. The Reserve Bank may monitor the risk profile of banks on an ongoing basis. Towards this, the Capital Adequacy, Asset Quality, Management, Earnings and Liquidity System (CAMELS) approach should be adjusted to accommodate the proposed focus and become the Capital Adequacy, Asset Quality, Risk Management, Earnings and Liquidity System (CARMELS) approach. Additionally, the Reserve Bank may undertake targeted appraisals of 'risk management systems' and 'corporate governance' in all banks at periodic intervals.

**1.6 Recommendations given by High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)**

*Weak institutions*

- Indian authorities should support consolidation of Indian firms in the financial sector through the unconstrained operation of natural market

processes – sizeable Indian financial conglomerates to emerge through acquisitions, mergers and takeovers. The aim should be to create a few Indian LCFIs led by the most capable and dynamic financial groups in India, the size of whose consolidated balance sheet exceeds US $ 500 bn.

- The control of branch licensing for banks is an anachronism at a time when India has moved away from the licence permit raj in most respects. As part of improving competition policy the opening of branches by domestic banks should now be immediately decontrolled. No domestic bank should have to ask the regulator for permission for each ATM or branch. One policy should be extended to all banks.
- Entry into domestic banking has been hampered by over-prescriptive and asymmetrical rules about ownership of banks. The time has come to remove the restrictions and permit unrestricted entry by Indian corporates in the banking sector and all other financial services. The discriminatory 10% ceiling on investments by corporates in banks is unjustifiable and should be removed immediately.

**1.7 Committee on Financial Sector Reforms (2008)**

- Allow more entry to private well-governed deposit-taking small finance banks, offsetting their higher risk from being geographically focused by requiring higher capital adequacy norms, a strict prohibition on related party transactions, and lower allowable concentration norms (loans as a share of capital that can be made to one party).
- Make significant efforts to create the supervisory capacity to deliver the greater monitoring that these banks will need initially, and put in place a tough prompt corrective action regime that ensures these banks do not become public charges.
- Liberalise the banking correspondent regulation so that a wide range of local agents can serve to extend financial services. Use technology both to reduce costs and to limit fraud and misrepresentation.
- Offer priority sector loan certificates (PSLC) to all entities that lend to eligible categories in the priority sector. Allow banks that undershoot their priority sector obligations to buy the PSLC and submit it towards fulfilment of their target.
- Liberalise the interest rate that institutions can charge, ensuring credit reaches the poor, but require (i) full transparency on the actual effective annualised interest cost of a loan to the borrower, (ii) periodic public disclosure of maximum and average interest rates charged by the lender to the priority sector, (iii) only loans that stay within a margin of local estimated costs of lending to the poor be eligible for PSLCs.
- Sell small under-performing public sector banks, possibly to another bank or to a strategic investor, to gain experience with the process and gauge outcomes.

- Create stronger boards for large public sector banks, with more power to outside shareholders (including possibly a private sector strategic investor), devolving the power to appoint and compensate top executives to the board.
- After starting the process of strengthening boards, delink the banks from additional government oversight, including by the Central Vigilance Commission and Parliament, with the justification that with government-controlled boards governing the banks, a second layer of oversight is not needed. Further ways to justify reduced government oversight is to create bank holding companies where the government only has a direct stake in the holding company. Another is to bring the direct government stake below 50 percent, perhaps through divestment to other public sector entities or provident funds, so that the government (broadly defined) has control, but the government (narrowly defined) cannot be considered the owner.
- Be more liberal in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks.
- Free banks to set up branches and ATMs anywhere.

## 2. Non-Banking Finance Companies

### 2.1 Report of Committee on the Financial System - Narasimham Committee (1998)

*Structural issues*

- DFIs should over a period of time convert into banks. There would then be only two forms of intermediaries, *viz.*, banks and NBFCs. If a DFI does not convert into bank in a stipulated timeframe, it would be categorised as an NBFC. A DFI which converts into a bank can be given some time to meet the requirements of commercial banks.
- Mergers between banks and banks and DFIs and NBFCs need to be based on synergies and locational and business-specific complementarities of concerned institutions and must obviously make sound commercial sense.
- All NBFCs are statutorily required to have a minimum net worth of Rs.25 lakh if they are to be registered. The minimum figure should be raised progressively to Rs.2 crore.
- Deposit insurance for NBFCs could blur the distinction between banks, which are closely regulated, and non-banks as far as safety of deposit is

concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection.

- Non-bank parties can be provided free access to bill rediscounts, commercial paper, certificate of deposits, Treasury bills and Money Market Mutual Funds.

## 3. Rural Financial Institutions

### 3.1 Report of Committee on the Financial System - Narasimham Committee (1998)

- A review of the capital structure of RRBs should be undertaken with a view to enlarging public subscription and give the sponsor banks greater ownership and responsibility in the operation of RRBs. While considering the issue of salaries of employees of RRBs, there should be no further dilution of the basic feature of RRBs as low-cost credit delivery institutions.
- Consideration of debt securitisation concept within the priority sector. This could enable banks which are not able to reach the priority sector target to purchase the debt from institutions which are able to lend beyond their mandated percentage.
- Banking policy should facilitate the evolution and growth of micro-credit institutions, including LABs which focus on agriculture, tiny and small-scale industries including such specialist institutions as may be promoted by NGOs for meeting the banking needs of the poor.

### 3.2 Committee on Financial Sector Reforms (2008)

- Supervision of all deposit taking institutions must come under the Reserve Bank. Situations where responsibility is shared, such as with the State Registrar of Co-operative Societies, should gradually cease. The Reserve Bank will have to increase supervisory capacity to take on this task. The Committee recognises that this involves constitutional issues but nevertheless recommends a thorough overhaul of the system of shared responsibility.

## 4. Insurance Sector

### 4.1 Advisory Group on Insurance Regulation (2000) and Review of the Recommendations (2004)

- Clearer distinction in legislation and regulations of IRDA and PFRDA needs to evolve in the overlapping areas.
- To carry out the development mandate and to protect the interests of policyholders and the inbuilt jurisdiction where the insurance contracts and insurance business is not defined, the allied services pertaining to rendering advice to insurers, insurance education, risk management and such other allied and actuarial services as detailed in WTO agreements could be permitted on the lines of Section 6(2)(h) of the LIC Act, 1956 on specific permission granted by the Authority.

- The suggestion to grant exemption to the Catastrophe Fund has not found favour with the Central Goverment for the time being. It could be reconsidered at an appropriate time.
- New private players already have sophisticated MIS system capable of generating statistics. Old players are also putting in place such MIS systems. IRDA could consider implementing this.

## 5. Regulatory Structure

### 5.1 Report of Committee on Financial System (Narasimham Committee II) (1998)

- The regulatory and supervisory authorities should take note of developments taking place elsewhere in the area of devising effective regulatory norms and to apply them in India taking into account the special characteristics but not in any way diluting the rigour of norms so that prescriptions match best practices abroad. It is equally important to recognise that pleas for regulatory forbearance, such as waiving adherence to regulations, to enable some banks more time to overcome their deficiencies could only compound their problems for the future and further emasculate their balance sheets.
- Duality of control over the co-operative credit institutions by State Governments and the Reserve Bank/NABARD should be eliminated and all co-operative banking institutions should come under the discipline of the BR Act under the aegis of the Reserve Bank/NABARD/BFS.

### 5.2 Financial Sector Assessment Program (2001)

- Laws such as the RBI Act should clearly state that any dismissal of the Governor of the Reserve Bank before the set end of his term must be based on grounds, such as gross malpractice or clearly failing health that are mentioned in the laws. Similar rules should also apply to the Deputy Governor of the Reserve Bank, responsible for regulation and supervision.
- Laws or regulations should clearly state the basis and limitations for the exchange of confidential supervisory information as well as rules for keeping and handling such information.

### 5.3 Report of the Committee on Fuller Capital Account Convertibility (2006)

- All commercial banks should be subject to a single Banking Legislation and separate legislative frameworks for groups of public sector banks

should be abrogated. All banks, including public sector banks, should be incorporated under the Companies Act; this would provide a level playing field.

**5.4 Recommendations given by High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)**

- The artificial barriers that have been erected between different segments of the financial markets, *viz.*, banking, insurance, capital markets, asset management activities and derivatives markets – so that they can be regulated separately by different regulators – should be dismantled. The regulatory arrangements and architecture should be rearranged to meet markets needs rather than having the market rearranged in order to meet the demands of regulatory convenience.

- The Central Goverment should conduct – using independent, impartial interlocutors including regulators from other IFCs – a periodic (3-5 yearly) Regulatory Impact Assessment of the financial regulatory regime. The RIA would aim to evaluate, using enhanced cost-benefit methodology, how efficient and cost-effective extant regulation is in meeting the main regulatory objectives and to understand what modifications are needed to improve it.

- When it comes to reconsidering regulatory architecture, whose foundations were set as early as 1934 with the RBI Act, although many amendments have been made since then, India has three options:

  a) Keeping the extant architecture in place with improved co-ordination and co-operation to reduce regulatory conflict, turf protection and achieve coherent, consistent regulation across the entire financial system.

  b) Partial consolidation of extant regulators into a tightly knit quartet covering (a) banking (b) insurance (c) pensions and (d) capital, derivatives and commodities markets. Any areas of activity that do not fall neatly into these four categories would be regulated automatically by a capital market regulator. The regulatory quartet would be presided over by a regulatory co-ordination committee chaired by a regulatory agency that regulates the largest part of the financial system.

  c) Evolve rapidly towards unified regulation with a single regulator for all financial services to avoid problems of co-ordination.

- While conceptually attracted to the unified principles based regulatory approach as the model for future, *i.e.*, the ideal that India should strive for in the long run, the movement in that direction should proceed at a pace that reflects the regulatory system's absorptive capacity for such a change. Whatever the policy makers decide on reforming regulatory architecture, there should be an early, if not immediate migration from

the rules-based regulation to principles-based regulation even under the extant architecture.

- As far as financial system regulation is concerned, two key priorities need to be addressed and enshrined in new legislation: (a) the regulatory approach and mindset adopted and (b) regulatory architecture. The present series of disparate legislation governing the Indian financial regime needs to be revamped and redrafted into a new Financial Services Modernisation Act that embraces the principles-based approach.
- A key task in reforming regulatory architecture is to place all regulatory and supervisory functions connected with all organised financial trading (currencies, bonds, equities, corporate bonds, commodity derivatives) into SEBI. This requires collecting all elements of law that are presently dispersed across many other acts including the RBI Act, Foreign Currency Regulation Act, and the Companies Act. The objectives of SEBI under the law should be to replicate the objectives and approach of UK-FSA. The new law governing financial system regulation should articulate broad principles and provide sufficient flexibility for more rapid financial innovation. The proposed new Act should also embed a redrafting of the BR Act, shifting towards principles-based regulation and giving banks greater flexibility in operations and management than is presently the case.
- As regards financial regime governance, India should immediately open up Direct Market Access on Indian exchanges to match the situation with foreign exchanges in other IFCs that provide a hospitable environment for algorithmic trading.

**5.5 Committee on Financial Sector Reforms (2008)**

- Parliament, through the Finance Ministry, and based on expert opinion as well as the principles enshrined in legislation, should set a specific remit for each regulator every five years. Every year, each regulator should report to a standing Committee (possibly the Standing Committee on Finance), explaining in its annual report the progress it has made on meeting the remit. The interactions should be made public.
- Regulatory actions should be subject to appeal to the Financial Sector Appellate Tribunal, which will be set up along the lines of, and subsume, the Securities Appellate Tribunal.

- The Committee recommends movement from a system where information is shared primarily among institutional credit providers on the basis of reciprocity to a system of subscription, where information is collected from more sources and a subscriber gets access to data subject to verification of 'need to know and authorisation to use' of the subscriber by the credit bureau.
- Allow holding company structures, with a parent holding company owning regulated subsidiaries. The holding company should be supervised by the Financial Sector Oversight Agency, with each regulated subsidiary supervised by the appropriate regulator. The holding company should be well diversified if it owns a bank.
- Bring all regulation of trading under the Securities and Exchange Board of India (SEBI).
- Rewrite financial sector regulation, with only clear objectives and regulatory principles outlined.
- Supervision of all deposit-taking institutions must come under the RBI. Situations where responsibility is shared, such as with the State Registrar of Co-operative Societies, should gradually cease. The Reserve Bank will have to increase supervisory capacity to take on this task. The Committee recognises that this involves constitutional issues, but nevertheless recommends a thorough overhaul of the system of shared responsibility.
- The Ministry of Corporate Affairs (MCA) should review accounts of unlisted companies, while SEBI should review accounts of listed companies.
- A Financial Sector Oversight Agency (FSOA) should be set up by statute. The FSOA's focus will be both macro-prudential as well as supervisory;. The FSOA will develop periodic assessments of macroeconomic risks, risk concentrations, as well as risk exposures in the economy; it will monitor the functioning of large, systemically important, financial conglomerates; anticipating potential risks, it will initiate balanced supervisory action by the concerned regulators to address those risks; it will address and defuse inter-regulatory conflicts, and look out for the build-up of systemic risks.
- The Committee recommends setting up a Working Group on Financial Sector Reforms with the Finance Minister as the Chairman. The main focus of this working group would be to shepherd financial sector reforms.
- Set up an Office of the Financial Ombudsman (OFO), incorporating all such offices in existing regulators, to serve as an interface between the household and industry.

## 6. Government Securities Market

### 6.1 Report of the Committee on Fuller Capital Account Convertibility (2006)

- Progressively increase share of mark-to-market category investments.

- Intra-day short selling needs to be extended to short selling across settlement cycles with adequate regulatory/ supervisory safeguards.
- Gilt funds should be exempted from dividend distribution tax and income up to a limit from direct investment in gilts could be exempted from tax.
- Introduction of STRIPS in government securities should be expedited.
- Allowing non-resident investors especially long-term investors like foreign central banks, endowment funds, and retirement funds.
- Widening the class of holders of government securities by allowing repo facility to all market players without any restrictions on minimum duration of repo.
- A rapid debt consolidation process that is tax neutral by exempting gains arising from exchange of securities from all taxes.
- Limits for FII investment in government securities to be linked to gross issuance in the previous year.

**6.2 Recommendations given by High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)**

- Short selling of bonds is of fundamental importance to obtain an arbitrage-free yield curve. A borrowing mechanism needs to be set up by exchanges to enable short selling in government bonds, corporate bonds and equities.

**6.3 Committee on Financial Sector Reforms (2008)**

- Steadily open up investment in the rupee corporate and government bond markets to foreign investors after a clear monetary policy framework is in place.

## 7. Foreign Exchange Market

**7.1 Report of the Committee on Fuller Capital Account Convertibility (2006)**

- The spot and forward markets should be liberalised and extended to all participants, removing the constraint on past performance/underlying exposures.
- Attention to be shown in protecting the interest of bank customers in terms of transparency of charges; the authorities need to be equally

concerned about bank margins on foreign exchange transactions of smaller customers. The Reserve Bank's intervention in foreign exchange market should be through the anonymous order matching system.

- FIIs may be provided with the facility of canceling and re-booking forward contracts and other derivatives booked to hedge rupee exposures.
- Currency futures may be introduced subject to risks being contained through proper trading mechanisms, structure of contracts and regulatory environment.
- Existing guaranteed settlement platform of CCIL needs to be extended to the forwards market.
- Banking sector should be allowed to hedge currency swaps by buying and selling without any monetary limits.

## 8. Money Market

### 8.1 Report of the Committee on Fuller Capital Account Convertibility (2006)

- Development of term money market as this would help to develop proper/ meaningful linkages between foreign exchange and domestic currency markets.
- HRD policies/ practices followed by a large part of the banking sector have to be significantly changed so that suitable staff is recruited and posted on a long-term basis and allowed to develop high-quality skills/ expertise in treasury operations, including foreign exchange dealings.
- Since CP and CD are short-term instruments, any unlimited opening up could have implications for short-term flows. Limits from prudential angle have to be considered.
- There is a need to develop a repo order matching screen for increasing the level of transparency and providing real-time information to the entire market. Opening of repo facility for corporates and other players to manage their liquidity through repo operations. Suitable regulatory changes need to be progressively introduced to enable more players to have access to the repo market. CBLO and repo markets could be expanded in scope to cover corporate debt instruments.
- Policy initiatives should be taken to facilitate development of different financial markets to encourage capital inflows. During this process, prudential regulations on inflow of foreign capital segment-wise would be desirable.
- In cases where the regulatory purview extends beyond one regulator, one of the regulators should be designated as lead regulator so that necessary co-ordination is ensured.

- Need to set up a dedicated cell within the Reserve Bank for tighter monitoring of all derivatives. This would be especially important as demand for derivatives could increase manifold to meet larger hedging requirements in the context of fuller capital account convertibility. Bank should have a well-laid down 'appropriateness policy' before complex structured derivatives are marketed to their clients. Efforts may be made to activate the market in interest rate futures to all participants including foreign investors. Permitted derivatives should include interest rate options, initially OTC, and subsequently exchange traded.
- Development of accounting standards for derivatives in line with international standards should be a priority. Banks should be allowed to trade in interest rate futures subject to prudential market risk management. FIIs in the debt market should also be permitted in all the derivatives market.
- Enactment of the Payment and Settlement legislation, followed by a swap clearing arrangement, with provisions for netting will need to be completed before opening up swap markets.
- FIMMDA to be empowered to act as an SRO to develop market ethics, trading standards and also undertake regulation of participants besides disseminating information.

## 9. Corporate Bond Market

### 9.1 Report of High Level Expert Committee on Corporate Bonds and Securitisation R H Patil Committee (2005)

*Market makers*

- A market-making scheme for corporate bonds should be evolved by market participant(s) willing to do so, including large intermediaries – such as banks, primary dealers and investment banks. A suitable framework needs to be put in place that incentivises efficient market-making and considers support mechanisms that market-makers need for this purpose including permission to undertake repos in corporate bonds.

*Clearing and Settlement System*

- As corporate bonds are governed by SCRA and SEBI regulations, the entities handling the clearing and settlement of these securities will

have to be recognised entities under the SEBI framework and SEBI will frame suitable regulations for the clearing and settlement of corporate bonds. However, in the case of trading, clearing and settlement of repos in corporate bonds, appropriate regulations will be framed by the Reserve Bank in consultation with SEBI.

- In order to ensure DVP settlements of corporate bonds in accordance with international best practices, the Reserve Bank may consider the issue of grant of suitable access to the concerned clearing and settlement entities to the RTGS system. This recommendation could be implemented in a phased manner:

  i) In Phase I, the trade reporting and dissemination system would be implemented and trades reported through the reporting systems will be accepted for clearing and settlement by the approved clearing entities. DVP I clearing could be offered for all corporate bonds and DVP III offered for those instruments that have sufficient liquidity;

  ii) Phase will include the introduction of tripartite repo contracts in corporate bonds, securities lending and borrowing and other mechanisms for reducing settlement risk. This will allow DVP III settlement to be offered for a larger universe of corporate debt securities;

  iii) In Phase III, the above trade reporting could migrate to STP-enabled order matching systems as well as DVP III settlements.

*Specialised Debt for Infrastructure Financing*

- In order not to restrict bank participation in the proposed Debt Funds, it is important that investments in these registered Debt Funds are not subject to 'capital market' exposure limits that the Reserve Bank applies to equity investments for banks. Further, investments in SEBI-registered Debt Funds should be treated in the same manner as bank investments in bonds and/ or debentures and should be accorded the same risk weightage as applicable to normal infrastructure credit.

*Fiscal Concession for Municipal Bonds and Infrastructure SPVs*

- Municipal bonds may be given some fiscal support with such support taking the form of bond insurance or providing credit enhancement so that municipalities are encouraged to issue such bonds for the development of urban infrastructure either on a standalone or on a pooled basis. A plan should be drawn for developing this market in India.

**9.2 Report of the Committee on Fuller Capital Account Convertibility (2006)**

- The Central Government/Reserve Bank and SEBI should be able to evolve a concerted approach to deal with the complex issues identified by the High Level Committee on the Corporate Bond Market.

- Institutional trading and settlement arrangement needs to be put in place and investors should have the freedom to join any trading and settlement platform they find convenient.
- Issuance of guidelines needs to be changed so as to recognise the institutional character of the market. Since issuers may like to tap the bond market more frequently than the equity market and subscribers are mainly institutional investors, issuance and listing mechanism in respect of instruments being placed with institutional investors should be simplified by relying more on assessment of the recognised rating agency rather than on voluminous and tedious disclosures as required by public issue of equities.
- Clearing and settlement arrangements like those offered by CCIL in the case of government securities should be in place to ensure guaranteed settlement.
- Stamp duties at time of bond issues as also on securitised debt should be abolished by all the State Governments.
- FII ceiling for investments in corporate bonds should in future be linked to fresh issuances.
- Corporate bonds may be permitted as eligible securities for repo transactions subject to strengthening regulatory and supervisory policies.

**9.3 Report of Committee on Infrastructure Financing (2007)**

*Patil Committee recommendations*

There is a need to expedite the implementation of the Patil Committee recommendations for the development of corporate bonds in the following areas:

- Removal of TDS on corporate bonds in line with government securities.
- Reduction and uniformity in stamp duty on issuance of debt instruments and on securitisation transactions.
- Allowing repo transactions on corporate bonds in inter-bank repo market through a specialised clearing and settlement platform.

*Efficiency of private placement market*

- Private placement to be confined to Qualified Institutional Buyers (QIBs) and the number restriction done away with.

- Develop an OTC market for trading in privately-placed debt securities. Further, an electronic trade reporting system should be devised to improve transparency in the OTC market.

*Regulatory asymmetry between loans and bonds*

- Banks should be allowed to invest in unrated and unlisted bonds issued by at least the infrastructure companies.
- Banks need to be given an option to classify their bond holdings under either the trading category (with mark-to-market implication) or HTM category (subject to only ALM norms). At a minimum, long-term infrastructure bonds (with maturity of more than 5 years) held by banks should be allowed to be classified under the HTM category up to 5% of their total liabilities.

### 9.4 High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)

*On missing markets*

- Indian IFC is handicapped by three key markets which are missing in India's financial system: (i) properly functioning, liquid corporate and sovereign bond market, (ii) a spot currency trading market, and (iii) broad derivatives markets that include exchange traded as well as tailored derivatives for the management of currency, interest rate and credit default risk. These three markets, termed BCD nexus, are interwoven by currency and interest rate arbitrage. If India is to have an IFC in Mumbai, the emphasis should be on having these missing BCD markets develop rapidly.
- The R H Patil Committee Report on domestic debt markets made a number of far-reaching recommendations which should be implemented as soon as possible. Further, there is a need to (a) bring all securities trading markets under the regulatory purview of regulator responsible for securities trading, *i.e.*, SEBI and (b) to ensure that platforms for trading all such debt instruments are transferred to BSE and NSE.
- An essential step for increasing the presence of INR denominated bonds in the global investment portfolio is to remove the quantitative restrictions so as to put INR bond purchases by FIs and other foreign buyers wishing to purchase INR denominated bonds in global markets on par with their equity purchases.
- There is need to shift trading in plain vanilla products (futures, options, and swaps) to exchanges, while retaining and expanding the OTC trading of transactions for exotic and tailor-made products.
- The Ministry of Finance needs to take stock of constraints that hold back exchange-traded interest rate derivatives including futures,

options, and swaps and obtain requisite modifications of regulations of insurance companies, banks, mutual funds and FIIs so as to get this critical component of BCD nexus off the ground immediately.

## 10. Credit Markets

### 10.1 The High Level Expert Committee on Corporate Bonds and Securitisation (2005)

*Taxation*

In order to resolve the uncertainty in taxation issues pertaining to securitised papers, the following measures are suggested:

- The Central Government should provide an explicit tax pass-through treatment to securitisation SPVs and NPA Securitisation SPVs (namely, trust SPVs set up by ARCs registered with the Reserve Bank under SARFAESI) on par with the tax pass-through treatment applied under the tax law to SEBI registered Venture Capital Funds under section 10(23FB) read with Section 115U of the Income Tax Act. The Reserve Bank and SEBI may frame appropriate regulations in this regard.
- Recognising the wholesale and QIB character of investors in securitisation trusts, there should be no withholding tax requirement on interest paid by the borrowers (whose credit exposures are securitised) to the securitisation trust. Similarly, there should be no requirement of withholding tax on distributions made by the securitisation trust to its PTC and/or SR holders. However, the securitisation trust may be required to file an annual return with the Income-tax Department in which all relevant particulars of the income distributions and the identity of the holders of PTCs and SRs may be included. This will safeguard against any possibility of revenue leakage.

*Issues under SARFAESI and Suggestions*

- With a view to deepen the investor base of QIBs which can invest in SRs, it is suggested that large-sized NBFC and non-NBFC corporate bodies established in India with net own funds in excess of, say, Rs.50 crore may be permitted to invest in SRs as QIBs. Similarly, private equity funds registered with SEBI as venture capital funds may also be permitted to invest in SRs within the limits that are applied for investment by venture capital funds into corporate bonds. These changes could be brought about through appropriate notification by the Central Government in exercise of its power u/s.2(m(iv) of the

SARFAESI Act or through notification by SEBI in pursuance of its powers u/s.2(u) of SARFAESI Act.

*Specialised Debt Funds for Infrastructure Financing*

- In order not to restrict bank participation in the proposed Debt Funds, it is important that investments in these registered Debt Funds are not subject to 'capital market' exposure limits that the Reserve Bank applies to equity investments for banks. Further, investments in SEBI-registered Debt Funds should be treated in the same manner as bank investments in bonds and/ or debentures and should be accorded the same risk weightage as applicable to normal infrastructure credit.

**10.2 Report of the Committee on Fuller Capital Account Convertibility (2006)**

- The Central Government should provide explicit tax pass-through treatment to securitisation SPVs on par with tax pass-through treatment granted to SEBI-registered venture capital funds.
- Securitised debt should be recognised under the Securities and Contract Regulation Act, 1956 as tradable debt.
- Limitations on FII to invest in securities issued by Asset Reconstruction Companies should be on par with their investment in listed securities.

**10.3 Report of the Committee on Infrastructure Financing (2007)**

*Securitisation*

- Inclusion of Pass-Through Certificates (PTCs) under the definition of 'security' as per SCRA, will enable the listing of these PTCs and thereby help in increasing the transparency of the market and tradability of the instrument.
- There are certain Reserve Bank guidelines not in line with international best practices and hence may need amendments to stimulate the growth of the securitisation market. They are as under:
- *Definition of the Originator*: Any group entities of the originator cannot participate in the securitisation transactions of the originator. As a general rule, since all securitisation transactions are conducted on an arm's length basis, this deprives group entities of the originator from profitable investment opportunities. In particular, some group entities which are regulated separately by distinct regulatory bodies like IRDA and SEBI, and which deal with funds raised from the public, could well be exempted from the ambit of the definition of 'originator'.
- *Capital adequacy*: Under the current guidelines, an originator may be required to maintain more capital than it would have, had the assets not been securitised. Hence, the total capital to be held by the originator against securitised exposures including for first loss, second loss and liquidity facility, should be capped at the capital required to be

maintained had the assets not been securitised. This is also in line with the regulations prevalent in Singapore and Basel II guidelines.

- *Profit recognition*: Reserve Bank guidelines require that any profit arising on account of sale of assets under securitisation program should be amortised over the life of the securities issued. This treatment of profits is inconsistent with the accounting treatment prescribed by ICAI's Guidance Note, FAS 140 and IAS 39. All these regulations require gain on assets sold to be booked at the time of completion of sale.
- *Release of credit enhancement*: Reserve Bank guidelines require that no portion of the credit enhancement should be released to the provider during the life of the securities issued by the SPV. It is a well-accepted international practice across the developed markets to gradually release the credit enhancement provided in a securitisation transaction.
- *Underwriting:* Any underwriting devolvement of securities issued by the SPV, on the originator in excess of 10 per cent (Reserve Bank of India vide letter dated October 4, 2006 to the Indian Banks' Association has increased this limit to 20 per cent) of the original amount of the issue has to be fully deducted from the capital. There is no economic rationale for such deduction as these investments do not create any additional risk on the originator over and above what would be the case had the assets not been securitised. This treatment, in general, is also not in line with other regulatory jurisdictions and the Basel II framework.
- *Put Options*: Reserve Bank guidelines prohibit the securities issued by the SPV from having any put options provided either by the originator or by third parties. The Reserve Bank vide letter dated October 4, 2006 to the Indian Banks' Association has allowed third parties to provide put options. Put option by originators should also be allowed and the capital treatment for such options should be similar as applicable to take-out financing.
- *Step-down subsidiary*: The current regulatory policies treat lending to step-down project SPVs floated by infrastructure companies under the group borrower limits, even if the lending is without recourse to the parent company. This provision does not add to the stability of banks but restricts their ability to lend. Hence, lending to step-down

subsidiary (without having recourse to the parent) should be exempt from the group exposure limit.

- *Underwriting*: Currently financial intermediaries are constrained by exposure norms in underwriting and origination-sell transactions. The exposure norms should not be applicable to such transactions where the intention is to sell off the exposure within a short period of time, say 6 months. Should the intermediaries fail to sell the exposure within the stipulated period, they may be asked to raise additional capital or write off the excess exposure from their capital or be prohibited from taking further exposures. This will help these financial intermediaries maintain confidentiality, manage timing mismatches and accelerate deal closure.

## 11. Equities market

### 11.1 Report of Committee on Infrastructure Financing (2007)

*Liberalising investment guidelines for equity instruments*

- *Dividend payment history:* As per current regulations, to qualify as an approved investment, the investee company should have a dividend payment record (of not less than 4% including bonus) for at least seven out of nine immediately preceding years for life companies. There are similar restrictions for non-life companies as well. It is recommended that dividend payment history as a consideration for equity investment be relaxed.
- *Inclusion of new instruments:* To further facilitate investment in equity of infrastructure companies, it is recommended that all equity investments in listed infrastructure companies be considered as approved investments. Also, to allow insurance companies to take advantage of the mutual funds with schemes targeted at investment (including equity) in infrastructure companies, investment in theses schemes may also be considered as approved investments.
- *Liberalising buyback regulations:* In the case of unlisted infrastructure companies, the buyback restrictions *vis-à-vis* vendors/suppliers should be liberalised. Sec 77A of Companies Act also does not allow using borrowed funds for buyback of equity shares, which implies that equity cannot be freed up during the course of a project even if the underlying risk profile improves. In certain infrastructure projects, such as UMPPs, the initial equity contribution required by the lenders may be high (say 30 percent of project cost). However, the lenders may be comfortable with a lower equity base when the project gets commissioned and starts generating stable cash flows. In such situations, leveraged recapitalisation, replacing equity with debt, should be allowed.
- *Change in initial bidders:* All bidding documents for infrastructure projects should provide a clause for dropping the initial bidder(s) or replacing them by a new entity, if agreed to by all the parties to the

contract through a deed of adherence. The deed of adherence will bind the new entity to the terms of the original contract. This provision should be included in the model concession agreement.

- *Venture or Private Equity funds as bidding partners:* To facilitate the participation of SEBI-registered venture funds/private equity funds, it is recommended that the criteria to qualify as bidding partners should be not the net worth of the private equity or venture investment manager, but the uncommitted investible funds managed by these entities and available for deployment.

**11.2 Committee on Financial Sector Reforms (2008)**

- Encourage the introduction of markets that are currently missing, such as exchange traded interest rate and exchange rate derivatives.
- Stop creating investor uncertainty by banning markets. If market manipulation is the worry, take direct action against those suspected of manipulation.
- Create the concept of one consolidated membership of an exchange for qualified investors (instead of the current need to obtain memberships for each product traded). Consolidated membership should confer the right to trade all the exchange's products on a unified trading screen with consolidated margining.
- Encourage the setting up of 'professional' markets and exchanges with a higher-order size, that are restricted to sophisticated investors (based on net worth and financial knowledge), where more sophisticated products can be traded.
- Create a more innovation-friendly environment, speeding up the process by which products are approved by focusing primarily on concerns of systemic risk, fraud, contract enforcement, transparency and inappropriate sales practices. The threshold for allowing products on professional exchanges (see proposal on consolidated membership stated in pre-page) or Over the Counter markets should be lower, so that experimentation can take place.
- Allow greater participation by foreign investors in domestic markets. Increase participation of domestic investors by reducing the extent to which regulators restrict an institutional investor's choice of investments. Move gradually instead to a 'prudent man' principle where the institutional investor is allowed to exercise judgment based

on what a prudent man might deem to be appropriate investments. Emphasise providing access to suitable equity-linked products to the broader population as part of the inclusion agenda.

## 12. Accounting & Auditing

### 12.1 Advisory Group on Accounting and Auditing (2001) and Review of the Recommendations (2004)

- The gap between International Accounting Standards (IAS) and those of the ICAI remains large. ICAI may take up on an emergency basis the issuance of standards on a comparable basis to IAS 30 (Disclosure in Financial Statements of Banks and Similar Financial Institutions), IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39.
- Where Indian standards diverge from international standards, Accounting Standards Board (ASB) should issue a note explaining the reasons.
- ASB should be an autonomous body within ICAI with its own staff and independent funding. Fulltime Chairman with members having technical expertise.
- A mechanism needs to be in place to ensure compliance with standards like SEC in the US. A panel within ICAI or outside could be set up for the purpose. Auditors could be obligated to report violations to this panel directly.

### 12.2 Committee on Fuller Capital Account Convertibility (2006)

- Banks should be encouraged to move towards full compliance with AS 11 without any approximations over a 5-year period. *'Complex'* banks should be required to comply with the AS within the next three years and other banks within the next five years.
- The ICAI has initiated a move in this regard for issuing corresponding Indian Standards assimilating the principles of IAS 39 on Financial Instruments: Recognition and Measurement, IAS 32: Financial Instruments: Disclosure and Presentation and IAS 30: Disclosures in financial statements of banks and similar financial institutions. This would ensure accounting of financial instruments, including derivatives, in a uniform and consistent manner. This would also foster better understanding of the risk exposures of various entities through the disclosures mandated under the accounting standards. Pending issue of the relevant accounting standards, the Reserve Bank should issue derivative accounting guidelines to banks adopting the broad principles of the above international standards. It would not be adequate if these accounting standards/ principles are mandated on the banks. These should also be made applicable to non-bank market participants (corporates). Hence, issue of these accounting standards (corresponding to IAS 32 and IAS 39) by ICAI would be necessary. The Reserve Bank should pursue this with ICAI.

- It would be useful to enhance the scope of disclosures under AS 25 to include qualitative aspects which will bring out the level and direction of risks assumed by the various entities, including non-banks, in consultation with ICAI. In the absence of ICAI making such disclosures an integral part of AS, the Reserve Bank should co-ordinate with the other regulators (SEBI for corporates and securities firms and IRDA for insurance firms).

## 13. Payment & Settlement Infrastructure

### 13.1 Advisory Group on Payment & Settlement Systems (2001) and Review of the Recommendations (2004)

- *Hiving off the management of DNS and RTGS systems from the Reserve Bank, with only settlement of funds to remain with the Reserve Bank:* It may be possible to hive off certain components of payment and settlement systems. The Reserve Bank may consider follow-up action in this regard. (It is being attempted for retail payments only).

## 14. Legal Infrastructure

### 14.1 Report of Committee on Financial System (Narasimham Committee II) - (1998)

- There is a case for reducing stamp duties and registration fees substantially by the State Governments.
- In view of the recent amendment to Section 28 of the Indian Contract Act, banks have expressed the fear that they can no longer limit their liabilities under bank guarantees to a specified period and that they would have to carry such guarantee commitments for long periods as outstanding obligations. Government departments do not generally return the original guarantee papers even after the purpose is served. The whole issue needs to be re-examined and bank guarantees exempted from the purview of recent amendments to Section 28 of the Indian Contract Act.

### 14.2 Advisory Group on Bankruptcy Laws (2001) and Review of the Recommendations (2004)

- A committee at the government level to draw up a separate legal framework for insolvency of banks and financial institutions could be considered
- Before adoption of the UNCITRAL model, a committee could be constituted to study how the model can be adopted in India and what

necessary recommendations could be made to the Central Government.

### 14.3 Recommendations given by High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)

- Create an International Financial Services Appellate Tribunal (IFSAT) covering all aspects of finance. IFSAT should offer a comprehensive appeals procedure against all actions of financial regulators where judges have specialised financial domain knowledge

### 14.4 Committee on Financial Sector Reforms (2008)

- Ongoing efforts to improve land registration and titling – including full cadastral mapping of land, reconciling various registries, forcing compulsory registration of all land transactions, computerising land records, and providing easy remote access to land records – should be expedited, with the Center playing a role in facilitating pilots and sharing experiences of best practices. The Committee also suggests that the possibility of special law courts to clear the backlog of land disputes be examined.
- Encourage the entry of more well-capitalised ARCs, including ones with foreign backing.
- Restrictions on tenancy should be re-examined so that tenancy can be formalised in contracts, which can then serve as the basis for borrowing.
- The powers of SARFAESI that are currently conferred only on banks, public financial institutions, and housing finance companies should be extended to all institutional lenders.
- The Committee outlines a number of desirable attributes of a bankruptcy code in the Indian context, many of which are aligned with the recommendations of the Irani Committee. An expedited move to legislate the needed amendments to company law.

## 15. Monetary Policy

### 15.1 Advisory Group on Transparency in Monetary & Financial Policies (2000) and Review of the Recommendations (2004)

- *Setting objectives of monetary policy*: A consensus could be sought over a medium-term horizon, with a view to evolving a hierarchy of objectives that could be transparently communicated.
- *Constitution of Monetary Policy Committee (MPC)*: If MPC is to be constituted as a Committee of the Board of Directors, it could be done without an amendment to the RBI Act.

### 15.2 Committee on Fuller Capital Account Convertibility (2006)

- *Objectives:* The Reserve Bank and the government should jointly set out the objective of monetary policy for a specific period and put it in the public domain.

- *Constitution of Monetary Policy Committee (MPC)*: Formal MPC should be set up. At some appropriate stage, summary of minutes should be put in the public domain with a suitable lag.

*Monetary Policy Instruments and Operations:*

- Actively use the instrument of reserve requirement.
- The Reserve Bank should build up its stock in government securities so as to undertake effective OMO.
- In order to address the shortage of instruments:
- The Reserve Bank should activate variable rate repo/ reverse repo auctions or repo/reverse repo operations on a real time basis.
- The Reserve Bank should consider somewhat longer term LAF.
- CRR and SLR could be supportive instruments for less transient liquidity inflows.

### 15.3 High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)

- The Reserve Bank needs to consider focussing exclusively on a single task of managing a key short-term base rate to maintain price stability (*e.g.*, inflation being kept in the range of 3-4%) consistent with supporting a high growth rate of 8-10%.

### 15.4 Committee on Financial Sector Reforms (2008)

- The Reserve Bank should formally have a single objective to stay close to a low inflation number or within a range, in the medium term, and move steadily to a single instrument, the short term interest rate (repo and reverse repo), to achieve it.

## 16. Financial Policies

### 16.1 Committee on Fuller Capital Account Convertibility (2006)

*Disclosures*

The disclosures to be made by banks in future should include the following, in addition to the disclosures required by Basel II guidelines:

- Concentration of deposit base.
- Concentration of borrowings.
- Extent of dependence on models for risk management and pricing purposes.

- Framework in place for building and validating models.
- Disclosure should shift from the position as on the date of balance sheet to the average during the year.
- Currency-wise maturity pattern of deposits and liabilities where the position exceeds a certain percentage of total assets or liabilities.
- Disclosures on managed assets basis for securitised and assigned assets.
- Disclosure of top 20 shareholders.
- Make segment disclosures in greater detail – to include 'corporate', 'retail' and 'priority' sectors, including disclosures pertaining to movement of NPAs in these segments.
- Greater disclosures on contingent liabilities, including comfort letters.
- Bank's holding out policy towards their subsidiaries/joint ventures/ associates.

## 17. External Sector

### 17.1 Committee on Fuller Capital Account Convertibility (2006)

- Management of the level of exchange rate is more important than managing volatility. In this context, the Reserve Bank should refine the REER index by incorporation of services to the extent possible. Periods where there are large duty adjustments should be built into the construction of REER. The Reserve Bank should have a Monitoring Exchange Band of +/- 5.0 per cent around the neutral REER and intervene only when the band is breached under normal circumstances. The Reserve Bank should undertake a periodic review of the neutral REER, which could be changed as warranted by fundamentals.
- Greater attention is required to the concept of reserve adequacy in the context of external liabilities. As an operative rule, if CAD persists beyond 3 per cent of GDP, the exchange rate policy should be reviewed.
- There are data concerns. The Reserve Bank should undertake an in-depth examination of the coverage and accuracy of data.

### 17.2 High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)

- Issues like the viability of maintaining a stable exchange rate for INR; whether that rate should be managed around a notional central USD peg or a different trade/investment weighted currency basket; and whether official intervention in currency markets to stabilise the INR should occur except in extreme circumstances, examined by CAC, need to be looked into further by a specialised expert technical committee. CAC needs to be achieved within the next 18-24 months, *i.e.*, by end of calendar year 2008 at the latest.

## 18. Fiscal Policy

### 18.1 Advisory Group on Fiscal Transparency (2001) and Review of the Recommendations (2004)

- *Information on Central Government institutions outside Central Government budg*ets: This could be considered by the Cental Government in consultation with different Cental Government Ministries, after taking into account the practical problem of delay in finalisation of accounts of central autonomous bodies due to the consolidation process.
- *Uniform budgetary practices at the State-le*vel: The Government Accounting Standard Advisory Board (GASAB) under the Comptroller & Auditor General (CAG) may examine this issue.
- *Quasi-Fiscal Activities*: The Finance Secretaries' Forum could set minimum standards on transparency, emphasising QFAs. CAG may examine the setting up of minimum standards and guide State Governments in this regard.

### 18.2 ROSC- Fiscal Transparency (2001)

- The budget documents should provide more background information and analysis to different assumptions about the macroeconomic outlook; explicit and implicit contingent liabilities that might have to be honoured, and other relevant factors should be assessed.
- *Contingent liabilities*: Greater clarity in accounting for the existing and prospective assistance provided to weak banks and PSUs.

### 18.3 Committee on Fuller Capital Account Convertibility (2006)

- Moderate public sector borrowing requirements and also contain total stock of liabilities.
- A substantial part of the revenue surplus of the Central Government should be earmarked to meet the repayment liability under the Central Government's market borrowing programme.
- The Central Government and States should graduate from the present system of fiscal deficit to a measure of Public Sector Borrowing Requirement (PSBR). The Reserve Bank should attempt a preliminary assessment of PSBR and put it in public domain, which would then facilitate the adoption of PSBR as a clearer indicator of public sector deficit.

### 18.4 High Powered Committee, Ministry of Finance, Government of India (Mumbai - An International Financial Centre) (2007)

- There should be progressive reduction of total public debt to GDP ratio from the current level of 80% of GDP to significantly lower figure. India needs to establish its own ratio for a debt/GDP ceiling after careful study as a nature accompaniment to FRBM deficit reduction targets.
- Eliminate transaction taxes in the form of Securities Transaction Tax (STT) and stamp duties. Apply GST to the financial services industry.
- The budgets and balance sheets of the State Governments and major metropolitan municipal corporations need to be restructured.
- Shift the burden of future infrastructure investment from the public to the private sector through PPPs to provide public goods and services on an appropriately structured basis that avoids risk of privatising profits while socialising costs.

## 19. Data Dissemination

### 19.1 Advisory Group on SDDS (2001) and Review of the Recommendations (2004)

- *Data on public sector (non-banking) operations* should be disseminated The Central Government (Ministry of Statistics and Programme Implementation, Ministry of Finance) and State Governments could consider necessary steps.
- *Dissemination of Central Government debt data by original as well as residual maturity.* The Reserve Bank could follow up this in consultation with the Central Government, so that dissemination of such data could be made possible over the medium term.

## 20. Others (Deposit Insurance/Financial Inclusion)

### 20.1 Committee on Financial Sector Reforms (2008)

- The Committee recommends strengthening the capacity of the Deposit Insurance and Credit Guarantee Corporation (DICGC) to both monitor risk and resolve a failing bank, instilling a more explicit system of prompt corrective action, and making deposit insurance premia more risk-based.
- The Committee recommends movement from a system where information is shared primarily amongst institutional credit providers on the basis of reciprocity to a system of subscription, where information is collected from more sources and a subscriber gets access to data subject to verification of 'need to know and authorisation to use' of the subscriber by the credit bureau. This will also require re-thinking the incentives of providers to share information, and a judicious mix of payments as well as mandatory requirements for information sharing will have to be developed.

- Expedite the process of creating a unique national ID number with biometric identification.
- Suitable standards for setting up catastrophe reserves should be evolved. This would require tax incentives and has not found favour with the Central Government for the time being. The Central Government and IRDA could review this at an appropriate time.